

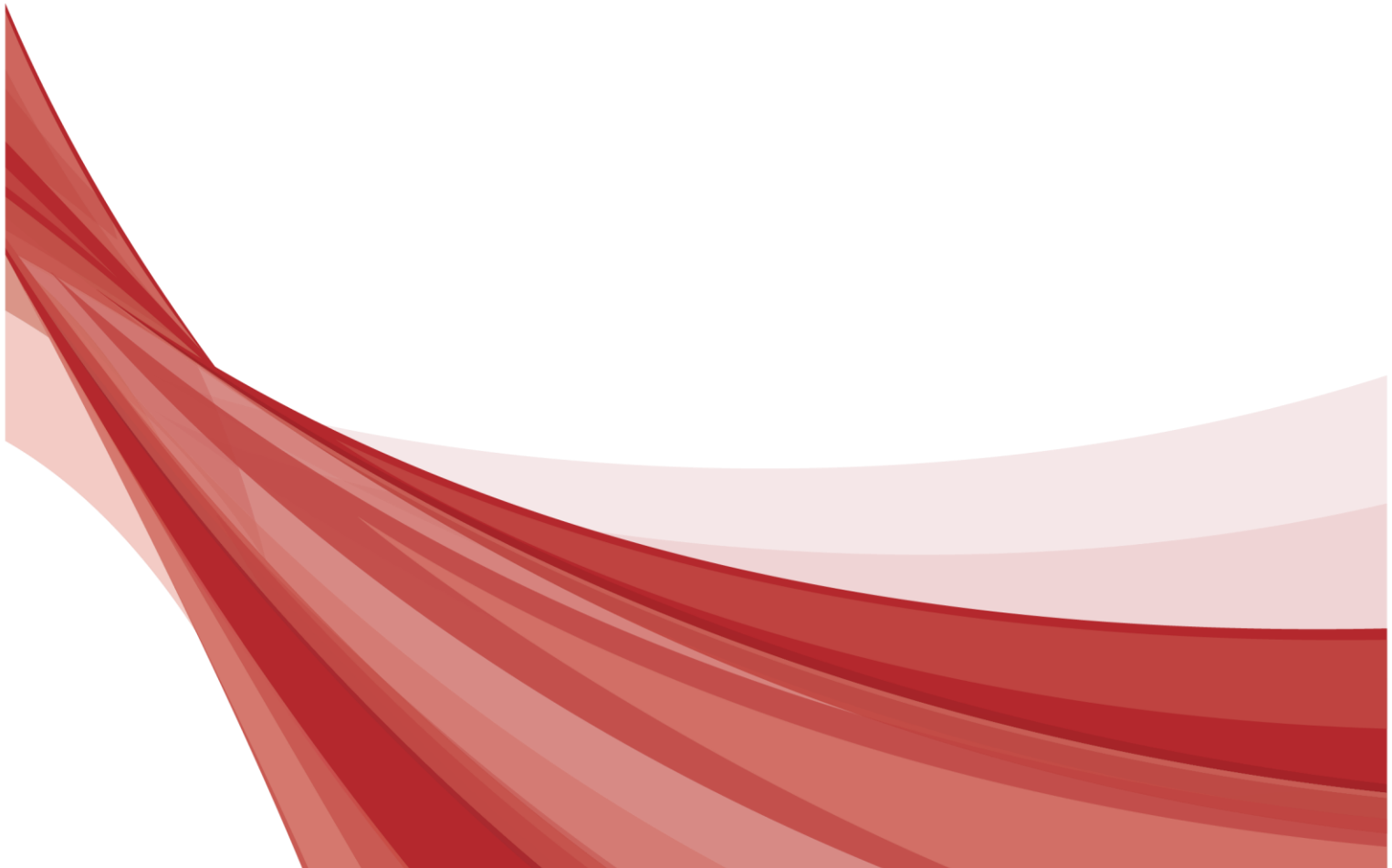


Financial markets that
work for society



An Economic and Social Audit of the 'City'

**A report by Mick McAteer of the Financial Inclusion Centre
for the TUC**



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Section one

Preface

The crisis of 2007-08 reminded us all that there were dangerous downsides to an economy over dependent on financial services for its growth.

Prosperity was revealed to have very insecure foundations, reliant on excessive private debts and speculative excesses in financial and property markets.

We were told that vast public resources were necessary to prevent the whole system caving in.

Catastrophe may have been averted. Next, austerity was prescribed as necessary medicine, with working people required to foot the bill for repairing excesses that were beyond their control.

Seven years after the start of austerity and ten after the start of the financial crisis, the outlook is still very uncertain. The financial crisis may have ended, but conditions for working people are still dismal, with the most severe real wages crisis for at least 150 years and greatly increased insecurity at work. Post-crisis economic growth is well below historic norms, with activity still propped up by consumer spending in spite of the living standards crisis.

And it is far from clear whether the financial sector is effectively supporting the rest of the economy. While the sector is willing to offer secured lending, the property market is increasingly out of reach of working people; and over the past year there is growing alarm at the scale of consumer credit. Lending to businesses has been negative in six out of the last eight years, and even now remains subdued. And this is in spite of the Government and Bank of England still keeping open the emergency support taps, including, for example, quantitative easing and an additional funding scheme for banks.

At the coal face, in spite of this vast support, the reality for people working in retail banks up and down the country is large scale closures. The banking industry is becoming disconnected from the people and businesses that they should serve.

Many people have spent time analysing the problems within the financial sector that led to the crash, and the anaemic growth in the post-crash period. But working people are at the sharp end of this, dependent for their standard of living on an economy that operates to produce decent and fulfilling work. No matter how complicated the issue, it is right that working people engage in the discussion and have our voice heard.

The referendum on membership of the EU is forcing a rethink about how the financial sector works. While we all worry about the loss of high value jobs to other countries, we must take this opportunity to fundamental questions about what sort of financial sector will best serve working people.

Preface

We greatly welcome Mick McAteer's report as an incredibly rich and hugely valuable contribution to these discussions.

Frances O'Grady

General Secretary

Section two

Introduction and Summary

Modern societies need a well-functioning financial sector that meets the needs of households and businesses in the ‘real economy’. The UK’s financial sector is huge and sophisticated and makes a major contribution to the UK economy both in terms of its direct contribution to GDP and services provided to the real economy. It is no wonder that the future of the City has featured so prominently in the debate about the UK economy post-Brexit.

The City’s influential lobbyists are effective at promoting the benefits – so much so that policymakers are reluctant to introduce serious reforms that would radically change the scale and structure of the city for fear of *‘killing the golden goose’*. But to get a more balanced picture of the true value of the City, we must consider the economic and social costs. This same dependency on the City means the UK economy is very vulnerable to risky behaviours and market failure in the huge wholesale and institutional financial markets.

The costs of failure in retail financial services (such as misselling scandals or weak competition in banking) have been well-documented. There have also been a few attempts to estimate the costs associated with the financial crisis. But, there have been surprisingly few attempts to pull together the available evidence on the full range of costs associated with financial market activities and how well the City performs its primary functions from the perspective of the end user¹. This is not just of academic interest. Consumer organisations are effective at holding retail financial services providers to account. But the lack of evidence and focus means that the larger, more powerful wholesale and institutional markets and infrastructure providers receive little scrutiny from civil society. This hinders necessary reform.

With this in mind, the TUC asked The Financial Inclusion Centre to produce a report to:

- Map the main functions of the UK financial sector (the City) grouped around its primary activities,² markets, institutions and products.³

¹ For example, industry, SMEs, and consumers

² Banking, money transmission and payment systems; asset management (the allocation of resources within the financial and economic system and asset management); financial intermediation and credit creation; and insurance and risk management/ derivatives.

³ These activities are undertaken in the capital, wholesale, and institutional markets by various institutions and infrastructures, including stock exchanges, clearing and settlement houses, various payment systems, investment banks, stockbrokers, institutional fund/asset managers (including sovereign wealth funds), private equity/ venture capital providers and managers, hedge funds, the shadow banking system, and various service providers such as analysts, ratings agencies, and information providers.

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- Suggest a framework to assess the economic and social utility of the City;
- Provide some preliminary data on the benefits created and detriment caused by the activities in the financial sector, and assessment of risks created by the City's activities; and
- Map out the potential risks and opportunities for reform in a post-Brexit world.
- The economic and social audit framework is built around four key themes:
 - Costs relating to conduct of business failures, misselling, poor culture and integrity;
 - Economic and social utility;
 - Negative externalities and social costs; and
 - Financial stability and resilience, and wider effects on economic resilience.

This report attempts to pull together the available research on the benefits and costs to the economy and society. Of course, it is not possible to arrive at a discrete number which quantifies the net worth of the City along the lines of: the City contributes £X bn to the UK's GDP; but the total welfare loss/ value extracted is equal to £Y bn; therefore the net worth of the City is equal to £Z bn. Nevertheless, pulling together these costs in one place allows us to put in context the claims about the value created by the City to provide a more realistic assessment of its worth to the wider economy and society.

KEY DATA ON THE FINANCIAL SECTOR⁴

Retail financial services

This section sets out the scale of the UK's retail financial sector. Millions of UK households use the financial services industry.

- 97% of UK households have some form of transactional payment account. There are 7 bn banking transactions and 2.3 bn ATM withdrawals a year. UK households and non-financial corporations (NFCs) have £1.66 trn on deposit (households' £1.29 trn, NFCs £371 bn). UK households owe £1.53 trn (£1.33 trn mortgages outstanding). Taking into account households who own their home outright, two-thirds of households own their home as a result of having a mortgage. Households owe £198 bn in unsecured consumer credit. £68 bn of this is credit card debt – 60% of UK adults hold at least one credit card. Total loans outstanding to NFCs is £456 bn - £291 bn to larger firms, £164 bn to SMEs.
- The alternative finance sector is growing but still represents a small fraction of financial services. Peer-to-peer (P2P) loans outstanding are now £3.5 bn; 181,000 lend through P2P with 420,000 borrowing. There are 462 credit unions, with 1.7 m members, loans outstanding of £1.25 bn, and shares/ savings of £2.6 bn (note that Northern Irish and Scottish credit unions make up the bulk of the credit union sector). Responsible Finance Providers (formerly known as Community Development Finance Institutions – CDFIs) lent £242 m to 47,500 customers in 2015.
- Over 11 m people are active members of employer pension schemes; nearly 11 m are currently receiving a pension from an employers' scheme; while nearly 12 m have preserved benefits. Nearly 12 m are members of personal pension schemes – 7.9m are currently contributing. Overall, just over 14 m are currently contributing to some form of private pension.
- Three quarters of households have contents and motor insurance, while two thirds have structural insurance. UK insurers received £27 bn in general insurance premiums in 2015 – net premiums to the long term insurance sector were £116 bn.

Wholesale and institutional markets, payment systems

If retail financial services is impressive, the size of the UK's wholesale and institutional financial markets and payment systems is staggering. The UK's financial sector is much larger as a proportion of GDP than its major economic rivals – the gap has grown over time and is set to grow even further.

- The value of financial assets owned by banks and other financial institutions was around £20 trn as at 2014 – 1,200% of UK GDP. The equivalent for the USA was

⁴ Sources can be found in main report. Note that we have used the most current data and reports where available. But this has not always been possible particularly when it comes to comparative data - for example, data comparing the UK financial sector to international competitors or size of the financial system compared to GDP. In these cases, we have used the most recent available which may be from 2013/14.

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just under 500%, France 600%, Japan 700% - even Switzerland known for its financial services was 900%. In 1978, the UK ratio was 200% of GDP.

- Looking at the UK banking system, assets were worth 450% of GDP in 2013, up from 100% in 1975 – but this is projected to grow to 950% by 2050. The UK banking system as a proportion of GDP is already much bigger than its major economic rivals – but this gap is expected to widen.
- The value of total assets managed in the UK is around £6 trn – nearly 80% of this is institutional client money. The UK asset management industry is the second largest in the world. UK pension fund assets are the second largest in the OECD. The UK insurance industry is the largest in Europe and the third largest in the world.
- The total value of payments made through the UK's payments and settlement systems in 2014 was £245 trn – 21 bn transactions worth £75 trn passed through the payments system alone.
- The sector makes a significant contribution to the UK economy including to the UK's trade balance – this has grown significantly over the years. The gross value added of the sector was £124 bn in 2014 - 8% of the UK economy. This had fallen since the financial crisis but still double the size in 2000. Including wider professional services the GVA was £190 bn – nearly 12% of GDP. 1.1 m are employed in the financial sector – 2.2 m if wider professional services are included.
- The wider financial services sector is estimated to have contributed £66 bn in tax in 2013/14 – 11.5% of total tax take. The sector accounts for around 15% of total private sector profitability – down from a peak of just under 23% in 2009 but well up from the historic level of around 3%.
- The financial sector trade balance (£38 bn) made up nearly half of the total service industry trade balance (£79 bn). The insurance and pensions sector trade balance alone was £21 bn. The trade surplus of wider financial and professional services was £72 bn. The UK is a bigger net exporter of financial services than major rivals – US, Japan, Germany, France, Italy, and Canada.
- Along with the sheer size of the City, the defining feature is its international nature – the UK is one of the leading (on several measures, the leading) global financial centres. There are 150 deposit taking foreign branches and 98 foreign subsidiaries of banks from 56 countries based in the UK. Foreign banks make up nearly half of all banking assets. Foreign branches account for 30% of UK bank assets and one-third of interbank lending. Nearly 20% of all global banking activity is booked in London.
- The foreign assets and liabilities of UK resident banks are worth more than 350% of GDP – four times the median figure for OECD countries. £600 bn of foreign exchange is traded in London every day (40% of global foreign exchange volume). Half of all trades in over-the-counter interest rate derivatives, 40% of foreign

exchange derivatives, and 70% of international bonds take place in London. The value of European derivatives outstanding is Euro200 trn – the bulk of which are traded in London.

- London's importance as a global financial centre has been growing. Overseas clients represent 40% of total assets under management – nearly half of this is from European clients. 58% of asset management firms in London are overseas firms. £775 bn of assets domiciled overseas is actually managed in London. 65% of Fortune 500 companies have their European headquarters in London.
- As well as being a leading centre for the more established financial services such as investment banking, asset management, and insurance, the City is one of the leading centres for the new fintech industries.

THE ECONOMIC AND SOCIAL COSTS

Set against the undeniable contribution of the city to economic growth within the UK, are the economic and social costs, and risks it creates. Indeed, many of the very features of the City which produce value for the UK (the contribution towards GDP, the sheer scale and global nature of the UK's financial markets) create those costs and risks. In addition to risks and costs, there are fundamental questions to be asked about the economic and social utility of the financial sector. The charge sheet against the City is long and serious.

The report sets out four areas where the economic and social performance of the City is in doubt.

First, there is significant evidence that poor conduct and misselling within the industry have not only led to losses for individuals and businesses, but a significant loss of trust.

Second, there are questions to be asked as to whether the City is performing its core functions effectively; high charges and poor performance can be seen as extracting value from the real economy, and there is significant evidence that the City is failing to allocate capital effectively to productive investments, instead, creating asset bubbles and ever greater activity within financial services.

Third, the social costs of the city should be taken into account; in particular, the impact of a large financial sector on the UK's level of inequality.

And finally, while Brexit is posing a challenge to the resilience of the City, we need to ask whether the City itself still has a destabilising impact on the rest of the economy even after regulatory reforms aimed at making the system more stable.

1. Conduct of business, poor culture and integrity

The sector has faced huge redress costs as a result of poor conduct and misselling to retail customers and real economy firms. These redress costs have had wider effects on the functioning of the banking sector – costs have hit the bottom line, constraining the capital available to support lending to the real economy.

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The combined misselling costs for all the major retail misselling scandals over the past 30 years has now reached £45 bn– payment protection insurance (PPI) misselling is the largest cost. UK banks paid out a total of £30 bn between 2009 and 2014 – the same as the amount of capital raised by them to repair balance sheets. A further £26 bn has been paid out to 4.5 m customers of firms that have gone bust since 2001.

Conflicts of interest and poor conduct are not limited to retail financial services. Costs associated with manipulating Libor are estimated to have cost investment banks \$6 bn on a global basis (possibly rising to \$22 bn) with fines for manipulating foreign exchange markets possibly greater. Overall, the major UK banks made provisions for total conduct costs of £56 bn on a rolling five year basis (2010-14) – double the total in 2008-12.

The Financial Conduct Authority (FCA) has found widespread problems with market integrity and conflicts of interest in the wholesale and institutional financial markets. Despite numerous allegations of misconduct in the wholesale and capital markets, there have been just seven criminal convictions in the UK for insider dealing with a further five for market abuse since 2005 compared to 534 in the US over the same period – 40 times more convictions in the US even though the US stockmarket is around five times larger.

Confidence and trust in the financial sector has been badly affected. Small firms remain reluctant to borrow from banks and financial services remains one of the least trusted consumer sectors. This affects consumers' propensity to save for future needs such as a pension so creating longer term public policy problems, including the perceived attractiveness of property as a pension, contributing to house price bubbles (recently in the form of buy-to-let investment) – in turn diverting resources away from the real economy.

2. Is the city efficiently allocating capital?

Market inefficiency and value extraction

Poor conduct and retail misselling cases and market inefficiency in retail financial services (such as weak competition in banking and savings accounts) have received a very high profile. But, the cost of market failure in the form of value extraction and poor performance in the vital pensions and investment industry alone has been of a magnitude greater. Value extraction doesn't just mean that consumers have to save more to compensate for high charges, it means that less resource actually gets to the real economy in the form of long term investment capital.

The extent of market failure in the critical asset management industry is staggering. 70% of investment funds underperformed their benchmark over the past 10 years. Tens of £bn has been extracted each year through high charges, poor performance and asset allocation. The FCA found that the high costs incurred by active investment managers reduced the size of a typical investor's fund by 44% over 20 years. Local government schemes alone are estimated to have been losing £2 bn a year through high charges and underperformance. Given that the majority of 'active' fund

managers underperform their benchmarks over the long term, these unnecessary costs are value extraction in its truest sense.

In addition to value extraction, the short termism of institutional investors affects the ability of real economy firms to plan for the future and invest in research and development – which further undermines long term economic sustainability and productivity. The average length of time shares are held by investors in the UK stockmarket is now 6 months (down from almost 8 years in the 1960s). Two-thirds of turnover on the UK market is accounted for by hedge funds and high frequency traders – not known for their long term approach to investing. Pressure to generate short term returns (through share buybacks and high dividend payments) affects the ability of real economy firms to invest for the future.

Misallocation of resources and impacts on the real economy

Major questions remain about whether the financial sector serves the real economy rather than primarily extracting value from already existing assets – or indeed manufacturing synthetic assets from which to extract value. Analysis from the Bank of England published in 2015 showed that the bulk of global investment bank revenue (75%) in 2013 was derived from providing services to other parts of the financial system rather than to real economy firms.

The financial crisis has had a major impact on long term economic output and productivity. If productivity had been maintained at pre-crisis levels it would be around 20% higher than it is now. Latest projections estimate that the productivity gap will widen to 24% by 2021. And estimates for the value of long term lost output due to the financial crisis range from £1.8 trn to £7.4 trn.

But, it seems that greater financialisation and misallocation of resources by the financial sector also has ongoing economic effects. Financialisation diverts resources away from real economy activities and fuels asset price bubbles which then increases the risk of financial crisis with further consequences for the real economy. Financialisation can amplify boom and bust cycles in the real economy. There is a strong case for saying that if the UK financial sector had been smaller pre crisis, the subsequent crisis would not have been as deep and prolonged.

It isn't just vulnerability to financial crises which causes concern. Greater financialisation harms real economy productivity and is negatively linked with growth in GDP - particularly if it associated with misallocation of resources into existing assets such as housing rather than new, productive assets.

As well as crowding out investment in real economy activities through misallocation of resources (see above), greater financialisation was accompanied by greater capital flows into the UK which may have kept the sterling exchange rate higher than it would have been, affecting the competitiveness of the manufacturing sector. Some of the pre financial crisis excesses are now being unwound for example, lending to other financial business fell post crisis. But banks stand accused of not providing enough finance to the real economy. Lending to real economy firms is still weak compared to pre-crisis levels. Last year lending to real economy firms was only a

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small proportion of total lending – and much smaller than mortgage lending, consumer credit and lending to other financial businesses.

Most recently, we are seeing major distortions in the financial markets as manifest by the ‘flight to quality’ and at the same time the ‘search for yield’. Huge amounts of investment capital is now held in negative yielding high quality government and corporate bonds. To compensate, investors are searching for yield by investing in high risk investments or investment strategies or in property. Concerted efforts by policymakers to stimulate economies by maintaining low interest rates do not appear to be encouraging investors to provide long term capital to real economy firms. If anything, it could be argued that productive investment is falling into the gap created by the two powerful investment trends pulling in opposite directions. These distortions not only represent a misallocation of resources but may be creating new systemic risks in the financial system

3. Social costs and externalities

The direct and indirect costs of the financial crisis have been huge. In terms of direct costs, at its peak £1.16 trn of support was provided to the banks. The amount outstanding is still £115 bn.

There are also other indirect costs to consider. When financial services play a bigger role in economies beyond a certain point, this can contribute to wider economic inequality – both asset and income inequality. The ratio of earnings in the financial sector to the rest of the economy has grown over the years. 40% of top decile earners in the UK work in the financial sector. Research has found that an increase in credit intermediation is associated with higher income growth for the top income decile of a population but lower growth for the 90%. Asset price bubbles also undermine household financial resilience. The growth in financial sector salaries and bonuses has contributed to wage inequality. Moreover, the level of salaries in the financial sector appeared to affect real economy firms by luring the best talent away – especially in research intensive industries.

The city also has a poor record with regards to diversity within its own ranks; around 80% of the FCA’s Approved Persons are male.

There is also little sign that the City is engaged with tackling wider problems where its financial clout means it could wield significant influence. Although there has been progress, the institutional investment and insurance industries still fail to exercise due diligence and underestimate the financial risks associated with climate change. And the activities of the wider professional services firms are estimated to be losing the UK Exchequer £bns a year in lost revenue through advice on tax avoidance.

4. Financial stability and economic resilience

The financial crisis in 2007-08 was unusual in the nearly catastrophic impact it had on our financial system (the first phase financial crisis), the way it spread out to the real economy in the form of a major recession (second phase economic crisis), and the social costs (third phase social crisis). Post crisis, major financial stability and

prudential regulatory reforms were introduced to try to make our financial system and systemically important financial institutions safer and to protect the real economy from the consequences of financial crises. We won't know for sure whether these reforms go far enough unless the financial system is tested by another crisis.

But concerns remain that the continued reliance on the financial sector and its global nature leaves the UK vulnerable. The UK's market based financial system is six times the size of GDP – forecast to rise to 15 times by 2050. Risks are displaced to less well-regulated parts of the financial system such as the shadow banking sector. The sustained low interest rate environment (itself a response to the crisis) is causing investors to take undue risks in the search for yield and creating new asset price bubbles.

Concerns remain that the risks of contagion from the financial system have not been properly contained and that the financial system is nowhere near diverse enough to ensure financial resilience and continuity in the event of a new crisis. On some measures, the UK financial system is the least resilient of the major economies. The UK system does not have the necessary diversity and plurality to ensure resilience. Alternative financial providers have not made significant progress taking market share off the big financial institutions. The 'too big to fail' syndrome means the dominant financial institutions are able to repel any real attempts at reform.

Finally, there are clear risks associated with Brexit. On the one hand, there could be a significant economic impact of leaving the single market on the UK given how important the City is to the UK economy. On the other, outside the scope of common EU set rules, we could see new systemic, market integrity and conduct of business risks emerge if the City lobbyists are successful in pushing a deregulation agenda. And in the near term, the failure to negotiate a suitable deal could create financial stability risks.

NEXT STEPS AND FURTHER QUESTIONS

The major dilemma we face is: can we develop policies to address the risks and market failures identified without losing the benefits the City brings? This raises a series of policy questions, which we hope that this report provides an impetus to discuss:

- We need greater diversity in the financial system to reduce our reliance on 'too big to fail' financial institutions and improve competition and innovation. But, without major policy interventions to shape the financial system and create space for growth, it is very difficult to see how smaller institutions will achieve enough 'organic' growth to provide a real alternative. However, the fact that these institutions are too big to fail, means that policymakers may lack the courage to promote real change for fear of 'killing the golden goose'. **Is it possible to develop interventions which would change the structure of the UK financial system to promote economic resilience and greater diversity and plurality, and persuade policymakers to implement these policies?**

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- Generating revenue from overseas clients is per se a good thing for the UK economy – if it is done in a way that doesn't create costs that outweigh those benefits. **Is it possible to target policies which would ensure UK domestic clients get a better deal while still allowing the UK financial sector to generate significant revenues from overseas clients?** Linked to this, is the impact of Brexit. A 'hard-Brexit' could be a game changer given the importance of Europe to the UK's banking, insurance and investment management sectors.
- Restoring trust in the financial system is a priority. This won't happen unless the culture of the City also changes. Culture emerges from the system in which people operate – the structures, incentives, fear and greed etc. **But, do we know what it takes to restore trust in financial services?** Can we be sure the system has changed sufficiently to give us confidence that the dominant culture is changing?
- Misallocation of resources and short-termism are major issues, creating asset price bubbles and undermining sustainable economic growth. **Do we have the detailed, well thought through policies which would encourage more efficient resource allocation and long term thinking?**
- While the City makes a major contribution to GDP, too great a dependence on financial services appears to undermine productivity and sustainable economic growth. This suggests that we might be better off if the City was cut down to size. **But, if the City was "cut down to size", what would take its place? Would real economy activities fill the gap and offset the loss in contribution to GDP?** But this raises several related questions? Do we have the economic analytical framework to allow us to assess the impact on the UK economy if dependence on the City was reduced? Do we have the actual policies which would engineer the necessary rebalancing and, critically, would policymakers have the courage and opportunity to implement these policies?
- Despite a number of major regulatory reforms at international, EU and UK level fears remain that the UK economy remains vulnerable to financial system failure. Resilience would be improved if our financial system was more diverse. But system change on this scale takes a long time to deliver. In the meantime, more work is needed to provide reassurance that reforms are robust enough. The key questions are: **will ring fencing proposals protect retail banks from investment banking activities; and do the new capital requirements go far enough to safeguard retail banks?** These reforms will be tested if a disorderly Brexit creates new financial stability risks.

On a more positive note, Brexit may create a once-in-a-generation opportunity, and provide the impetus, for the reforms that many in civil society have been calling for to: make financial markets safer, reduce the impact of financial market crises on the real economy, rebalance the economy away from financial services, address short termism in financial markets, and improve the economic and social utility of the City so that it focuses less on proprietary activities and more on providing services that households and the real economy needs.

But, we must be realistic. It is not clear that civil society has the credible policies that would produce the desired reforms, or that there is the political will for reform on any real scale given the importance of the financial sector to the UK economy. Policymakers will need to be persuaded that the potential benefits of reform outweigh the potential costs.

Moreover, reform of any significance will be the work of years. In the near term, the focus of the Government and regulators will be on averting Brexit related systemic risks and minimising the economic impact of Brexit on the City (indeed the Government may ratchet up efforts to help the City attract more business from other parts of the global economy exacerbating the risks identified in this paper).

Reforming the City requires the right policies and regulators to implement those policies. The UK has a well-developed regulatory system for addressing conduct of business, consumer protection, competition, prudential regulation and financial stability issues. But we do not have the necessary institutional framework to deal with the wider economic and social costs identified in this report.

The final point relates to the capacity of civil society organisations to influence reform. Consumer groups have been effective at holding retail financial services firms to account (for example, obtaining redress for consumers affected by misselling). But wider civil society has not been that effective in scrutinising and holding to account wholesale and institutional financial markets. The necessary reforms will not happen unless civil society develops robust policies and influence policymakers. The question is: how do we ensure civil society builds capacity?

Overall, these questions can be summed up by asking: what should the City of London look like in a post-Brexit world; what role do we want it play in our economy; and do we have the policies, policy structures and political will to make the necessary reforms happen? These are big questions and we look forward to debating these with stakeholders over the coming years.

Section three

What does the City do? Mapping the key activities

In section 3, we illustrate how critically important the UK's financial services industry is to households, the real economy and wider society. But, before we do that, it is helpful to remind ourselves of what the financial sector does – what are the primary functions and activities, the types of financial institution and clients which operate in the market, the type of financial instruments and products sold by financial institutions and bought by clients, and how the financial services industry is regulated. A detailed Glossary can be found at the end of this report.

The UK's financial markets and services are huge and complex but, at its core, the sector has four primary functions. It:

- Provides banking and payments services allowing wages and bills to be paid, money transferred around the system and withdrawn from ATMs.
- Channels investment capital and loans to firms in the real economy (and to the Government) and in doing so allows households to save for the future (through pension, insurance and investment funds).
- Creates credit and money through the process of 'financial intermediation' and 'maturity transformation' providing mortgages and loans to households and real economy firms, and depositors with a return on their savings.
- Provides insurance and risk management services (for example, using derivatives) allowing households to insure themselves and their possessions, and firms to protect against economic risks such as foreign exchange or commodity price volatility.

The financial sector is meant to be a service industry in the truest sense. It should exist to provide products and services to households and real economy firms. It should intermediate between the various agents in the real economy - for example, firms seeking investment, governments wanting to borrow to invest in public services, consumers looking to borrow and, on the other side, investors willing to provide that investment or loans.

But, it is important to note that certain activities in financial markets are not undertaken for the ultimate economic benefit of 'end-users' such as households and real economy firms. Much of it is undertaken by financial institutions on a 'proprietary' basis – that is, to generate profits from trading and speculation rather than earning fees from developing and selling products and services to clients. This is

important to remember when we consider the risks created by and wider utility of the financial sector. We return to this later

Financial market activities

As financial consumers, we will be familiar with ‘retail’ financial services such as banks and building societies, insurance companies and pension funds. But those are just the visible part of a huge financial system consisting of the capital,⁵ wholesale,⁶ and institutional⁷ markets and financial infrastructures (including equity markets, bond markets, money markets, foreign exchange markets, wholesale and reinsurance markets, the shadow banking system, payment systems, and clearing and settlement systems).

To perform those primary functions outlined above, the financial sector undertakes a huge range of complex market activities categorised in the financial sector map below, see Chart 1.

These activities are undertaken in the markets by various financial institutions and infrastructure providers including: stock exchanges, clearing and settlement houses, various payment systems providers, investment banks, retail banks and building societies, wholesale and reinsurance insurers (including Lloyds of London), brokers, underwriters, stockbrokers, institutional fund/asset managers (including sovereign wealth funds), private equity/ venture capital providers and managers, hedge funds, and various service providers such as analysts, ratings agencies, and information providers.

To meet the needs of clients (and for their own proprietary purposes), financial institutions use a range of financial market instruments, products, and strategies. For example: credit default swaps (CDS), collateralised debt obligations (CDOs), special purpose vehicles (SPVs), securitisation, derivatives such as futures and options, SWAPS, UCIT funds, unit trusts and OEICS, unauthorised funds, closed-end funds (investment trusts), exchange traded funds, insurance products, life funds, pension funds, technical analysis, arbitrage trading, algorithmic trading (or ‘black box’ trading), high frequency trading.

⁵ Where capital in the form of equity and bonds is raised and equities, bonds and financial instruments traded

⁶ For the purpose of this paper, wholesale refers to business-to-business financial activities between large actors in the financial system such as investment banks and hedge funds, and dealings with large corporate clients in the real economy

⁷ Institutional in this sense refers to dealings with large clients such as pension funds, local authorities

What does the City do? Mapping the key activities

Chart 1: Map of financial market activities

WHOLESALE AND INSTITUTIONAL MARKETS	Markets and Market Infrastructure	Asset Management and Fund Services	Investment banking		Corporate Banking	Insurance (General insurance and life insurance)	Information and research provision	Professional services
	Primary Markets	Fund Management	Primary Markets	Secondary Markets / Market Making	Deposits / Lending	Insurance / reinsurance underwriting	Credit Rating	Actuarial services
	Secondary Markets	Collateral Management	Equity Capital Markets	Equity / FICC ⁸ Sales and Trading	Treasury and Transaction Banking	Broking / placement	Credit reference	Auditing and accounting
	Alternative trading venues ('dark pools')	Custody Banking	Debt Capital Markets	Agency Broking	Payment Systems	Advisory services	Financial data provision	Legal services
	Post-trade services	Fund Admin	Mergers and Acquisitions	Prime Brokerage	Advice	Claims Handling	News agency services	
	Benchmark Activities	Depository	Financing	Research and analytics	Risk Solutions	Markets and Market Infrastructure	Independent research analysis	
	Clearing and settlement systems					Lloyd's of London		
						Asset management		
RETAIL FINANCIAL SERVICES	Retail financial services activities – payments systems, retail and business banking, savings, mortgages, consumer credit, business loans, general insurance products, life insurance products, financial advisers, investment consultants, information providers. These products and services are increasingly delivered on-line and fintech channels							
THE END-USER	Households, real economy firms, charities, government, local government							

Source: schematic adapted from FCA Wholesale Sector Competition Review, p7, <https://www.fca.org.uk/your-fca/documents/feedback-statements/fs15-02>

Larger real economy firms and government agencies deal directly with wholesale and institutional markets. But 'ordinary' retail consumers and SMEs tend not to interact directly with these financial institutions and infrastructure providers and instead buy products and services from the retail financial services industry including retail banks, consumer credit firms, payment service providers, life and general insurers, asset management firms, financial advisers and increasingly via the internet.

However, it is important to note that even if ordinary consumers do not buy products and services directly from the wholesale and institutional markets, the security, price and quality of retail financial services products and services very much depends on wholesale market institutions such as investment banks.

The root cause of much of the welfare loss /detriment borne by ordinary households and SMEs in the real economy can be traced to wholesale or institutional market failures transmitted through the supply chain. For example: risky, opaque financial products designed to repair bank balance sheets sold to SMEs and pension schemes; huge pools of credit created in the wholesale markets repackaged in the form of credit products and cascaded down to retail borrowers leading to asset price bubbles (for example, in the housing market); and new business models which start off as useful innovations but end up creating unforeseen risks or destroying economic value

⁸ Fixed income (rates and credit), currency and commodities

(a prime example is securitisation - originally an economically useful financial innovation).

There is a direct but not well-understood link between market failure on the supply side of financial services and financial exclusion and underprovision. Market inefficiencies in wholesale and institutional markets and financial networks/ infrastructure can push up the unit costs of distributing products to consumers - this limits the pool of households who can be served viably.

Inefficient allocation of resources in wholesale/ institutional markets can deprive underserved households of products and services to meet their needs. There is also a clear supply chain effect in operation with products originating 'upstream' reducing in social utility/ increasing in price/ risk as they are distributed through the supply chain.

The creation of asset price bubbles as a result of behaviours and distortions in the wholesale markets can exacerbate wealth and income inequality. Financial crises which originate in the wholesale and institutional financial markets affect confidence and trust in the financial system with consequences for retirement planning, and access to financial products being withdrawn as markets over-correct.

Consumer groups have been very effective at holding retail financial services providers to account for numerous failures. But, the connection between market failure in the financial markets and retail financial services has not been particularly well-understood or even documented.

What does the City do? Mapping the key activities

How is the City regulated?

There are a number of agencies involved in regulating the UK financial system and markets. The key UK agencies we cover here are HM Treasury, the Bank of England/ Prudential Regulation Authority (PRA), and the Financial Conduct Authority (FCA).⁹

Moreover, as the debates around Brexit remind us, much of UK financial regulation is derived or influenced by EU and international regulation.

Previously the UK had a single, unified regulatory regime with the Financial Services Authority (FSA) responsible for: maintaining confidence in the financial system; financial stability; consumer protection; and reduction of financial crime. The Financial Services Act (2012) created a ‘twin peaks’ regime with financial stability and prudential regulation going to the Bank of England and ‘conduct’ regulation given to a new regulator called the Financial Conduct Authority (FCA).

HM Treasury

As the main government economic and finance ministry, primary responsibility for oversight of financial services policy lies with HM Treasury. Of course, ultimately HMT and the various statutory regulators are accountable to Parliament but it is HMT which determines the regulatory architecture and structure, the scope and remit of regulation¹⁰ (that is, which products are inside the regulatory ‘perimeter’ and subject to regulations), the statutory objectives and duties and powers available to the regulators.

Bank of England

The Bank of England is the lead authority in maintaining financial stability in the UK. It is the lender and market maker of ‘last resort’ to the financial system in the event of financial crises. Through the Financial Policy Committee (FPC) it aims to reduce risks to the financial system as a whole and through the Prudential Regulation Authority (PRA) ensuring the safety and soundness of important financial institutions (see below). It is also responsible for supervising the financial market infrastructure (including securities settlement systems, central counterparties, and recognised payment systems) and safely resolving failing financial institutions to minimise the impact on the rest of the financial system and real economy.

⁹ Note that much of the detailed policy on financial regulation comes from the European Union (EU) and the supervisory authorities which form the European system of financial supervision. These include: European Securities and Markets Authority (ESMA), European Banking Authority (EBA), and European Insurance and Occupational Pensions Authority (EIOPA). Many firms that operate in London will actually be authorised in another Member State but able to operate here due to ‘passporting’ arrangements. Moreover, the Competition and Markets Authority (CMA) can also intervene on relevant competition grounds. Insurance and pension companies and asset managers may also have to comply with The Pensions Regulator (TPR) regulations if they have workplace pension business.

¹⁰ Note also that the remit of regulation will often be decided at EU level.

Prudential Regulation Authority (PRA)

The PRA was set up as part of the Bank of England to create a ‘twin-peaks’¹¹ regulatory structure along with the FCA (see below).

The PRA is responsible for the prudential regulation of around 1,700 banks, building societies, insurers, major investment firms and credit unions. It has the following statutory objectives:

To promote the safety and soundness of the firms it regulates;

- A specific objective for insurers – to contribute to the securing of an appropriate degree of protection for those who are or may become policyholders; and
- A secondary objective to facilitate effective competition

Financial Conduct Authority

The FCA was created in April 2013 and is the conduct regulator for 56,000 firms. Although the PRA is the lead prudential regulator for larger financial institutions, the FCA still responsible for the prudential regulation of around 18,000 firms.¹² A range of firms are regulated for conduct by the FCA and prudentially regulated by the PRA.¹³ Other firms are regulated for conduct and prudentially regulated by the FCA.¹⁴

The FCA has an overarching strategic objective to ensure that the relevant markets it regulates function well. To support this, it has three operational objectives, which are to:

- secure an appropriate degree of protection for consumers;
- protect and enhance the integrity of the UK financial system; and
- promote effective competition in the interests of consumers.

When it discharges its functions, the FCA must also have regard to a number of regulatory principles.¹⁵

¹¹ Twin peaks refers to one agency being responsible for financial stability/ prudential regulation, the other responsible for consumer protection, market conduct, and competition issues.

¹² <https://www.fca.org.uk/about/the-fca>

¹³ Banks, Building societies, PRA-designated investment firms, Credit unions, Friendly societies, Life insurers, General insurers, Wholesale and commercial insurers and reinsurers, Lloyd’s and Lloyd’s Managing Agents

¹⁴ Personal investment firms, Insurance intermediaries, Mortgage intermediaries, Investment managers, Non-deposit taking lenders, Corporate finance firms, Wholesale firms, Custodians, Professional firms, Markets (exchanges and infrastructure providers), Collective investment schemes, Travel insurance firms, Media firms, Other brokers, Lloyd’s Members’ Agents, Non-designated investment firms, Consumer credit firms including debt management companies

¹⁵ Efficiency and economy; Proportionality; Sustainable Growth; Responsibility of consumers; Responsibility of senior management; Recognising the differences in the businesses carried on by different regulated persons; Openness and disclosure; and Transparency

What does the City do? Mapping the key activities

From the perspective of this paper, the most interesting one relates to ‘sustainable growth’ – that is, the FCA must have regard to *the desirability of sustainable growth in the economy of the UK in the medium or long term*.

In theory, this could allow the FCA to assess how well the wholesale and institutional financial markets are contributing to the real economy. But, *have regards* do not have the same effect as statutory objectives. We are not aware of any occasions where the FCA has systematically and objectively considered how well financial market activities meet the needs of the real economy – for example, the efficiency of financial intermediation, or how well financial markets allocate resources to the real economy.

Of course, this particular *have regard* could also be used to justify easing up on tough regulatory interventions on the grounds that it would undermine the ‘competitiveness’ of the City – the ability of the UK financial sector to attract overseas assets which as we show below make up a significant share of the business located in the City.

The existing competition objective can be used to assess competition *in* the wholesale/ institutional markets – indeed, the FCA has been undertaking wholesale market and asset management reviews. But, it is interesting that, given the importance of the City to the real economy, the statutory regulators do not have a clear statutory objective to assess whether financial markets work for the real economy.

There is a more general point to make about the interaction between regulation and public policy. As we explain later, the financial sector has created huge externality costs for the UK such as contributing to economic instability, affecting economic productivity, a focus on short-termism, misallocation of resources to unproductive activities, and exacerbating inequality. Yet financial regulators are not required to actively consider these externalities.

However, it could be argued that this area of policy is more the preserve of HM Treasury given the relevance for national economic policy. Nevertheless, it means there has been no real clear focus on the utility of the City to the economy and society, not least because HMT does not have the resources to do this.

The FCA also oversees the Payment Systems Regulator (PSR) which is the economic regulator for the £75 trn payments system in the UK. The PSR’s statutory objectives are:

- to ensure that payment systems are operated and developed in a way that considers and promotes the interests of all the businesses and consumers that use them;
- to promote effective competition in the markets for payment systems and services - between operators, PSPs and infrastructure providers; and
- to promote the development of and innovation in payment systems, in particular the infrastructure used to operate those systems.

The FCA also oversees the functioning of the Financial Ombudsman Service (FOS), the Financial Services Compensation Scheme (FSCS), and the Money Advice Service (MAS).

EU and International regulation

Much of the regulation of the UK financial sector is currently derived or influenced by EU and international legislation and regulation.

In section 6, we discuss the potential impact of Brexit on the financial sector. To identify which existing financial stability, conduct of business, and consumer protection measures might be affected, it is necessary to understand how EU legislation and regulation is applied in the UK. The EU Treaties¹⁶ which provide the constitutional basis for the European Union, establish the basis for the Single Market, and the four freedoms of movement (goods, services, capital and people) are enacted into UK law via the European Communities Act 1972 (ECA).¹⁷

But, the key EU legal instruments to consider are Directives and Regulations.

Regulations: these have direct effect in Member States, without any need to change domestic law (though Member States may have done so in order to remove resulting ambiguities and inconsistencies).

Directives: these tell Member States what legal results must be achieved, but leave it to each member state to bring about those results by means of domestic law. In the UK, this is done by primary legislation (mainly Acts of Parliament) or secondary legislation such as statutory instruments.

European Commission (EC): the Commission is the executive body of the European Union responsible for proposing and developing relevant legislation, implementing decisions, and upholding the various EU treaties.

European System of Financial Supervision (ESFS): the main bodies which comprise the ESFS are the **European Systemic Risk Board (ESRB)** and the **European Supervisory Authorities (ESAs)**. The ESRB is responsible for the oversight of financial stability regulation in the EU. The ESAs are responsible for prudential and conduct of business regulation. There are three ESAs: the Paris based European Securities and Markets Authority (ESMA) which regulates capital and investment markets; the London based (for now) European Banking Authority (EBA) which regulates the banking sector; and the Frankfurt based European Insurance and Occupational Pensions Authority (EIOPA) which regulates insurance markets and pensions. The ESAs play an important role in financial regulation as they develop the technical rules and standards to implement EU legislation.

¹⁶ The foundational treaty is the Treaty on European Union, which has gone through various iterations. Its latest version (2007) was shaped by the Lisbon Treaty, which inserted into the TEU the (in) famous Article 50.

¹⁷ It is this Act which the Great Repeal Bill will get rid off

What does the City do? Mapping the key activities

European Court of Justice (ECJ): as well as the Commission and European Supervisory Authorities (ESAs), the rulings of the ECJ can have a direct influence on UK financial services. For example, the Court ruled that from December 2012 insurers in the European Union could no longer use gender as a factor in the pricing of and determining benefits paid out from insurance policies.

Other international policymakers: the global nature of financial markets means that the development of many of important measures relating to financial stability and market integrity have been led by international political and regulatory bodies such as the G20, FSB, the Basel Committee, IOSCO, and IASB¹⁸ and hitherto implemented through EU legislation.

¹⁸ FSB, Financial Stability Board; Basel Committee, Basel Committee on Banking Supervision; IOSCO, International Organisation of Securities Commissions; IASB - International Association of Insurance Supervisors

Section four

Key data on the financial sector

In this section, we look at the main financial sectors in more detail including:

- Data on usage by households and real economy firms
- Aggregate data on size of wholesale and institutional markets, and payment systems
- The economic contribution of the financial sector
- The international context

Usage of financial services by households and real economy firms

First we look at retail financial services including data on size of markets and numbers of consumers using the main financial services.

Bank accounts

A bank account is the most common financial product held by households – and is the most common point of contact consumers have with the financial system. 97% of UK households¹⁹ have some form of direct payment account – current account, basic bank account and Post Office Card Account (POCA).²⁰ Salaries have been paid directly through the banking system for decades now and with social benefits now paid through the banking system, only a small minority of UK households are outside the banking system.

Deposits and savings

UK households and non-financial corporations (NFCs – ie. real economy firms) have a total of £1.6 trn on deposit with UK banks and building societies. UK households have over £1.3 trn while NFCs have £371 bn on deposit. In terms of notes and coins (cash), households hold £68 bn, with NFCs holding £6.1 bn.²¹

¹⁹ The raw numbers conceal the degree of financial exclusion in the UK. While a small minority do not have some form of payment account, many of these are just 'shell accounts' – that is, they are not used actively by consumers.

²⁰ FRS 13/14 Savings and Investment, Table 4.1: Households by type of savings and investments and by region/ country

²¹ Bank of England, BankStats, April 2017, Table A6.1

Key data on the financial sector

Total lending to households and the real economy

UK households now owe a total of £1.53 trillion, as at October 2016.²² Over 11 m households have a mortgage. The total value of mortgages/ secured debt outstanding stands at £1.33 trn.²³ Taking into account the number who own outright, two-thirds of households own their as a result of having a mortgage. Households owe a total of £198bn²⁴ in unsecured consumer credit, £68 bn of which is credit card debt.²⁵ According to the FCA, around 60% of UK adults hold at least one credit card product.²⁶

The total loans outstanding to non-financial corporations (ie the ‘real economy’) is £456 bn – this consists of £291 bn to large firms and £164 bn to SMEs.²⁷ This may seem like a large figure but as we show later, this is small compared to the amount of lending banks make to other financial institutions and the property market in its various forms.

Alternative finance

There are a number of alternative finance institutions in the UK including P2P lending, equity crowdfunding, and credit unions and other responsible finance providers. But these still only represent a small fraction of savings and loans provided by mainstream financial institutions.

The value of peer-to-peer (P2P) loans outstanding is around £3.5 bn – this comprises £2 bn to businesses and £1.5 bn to individuals. Around 181,000 people are lenders through P2P, with around 427,000 borrowers. P2P business lending accounts for 47% of P2P lending; P2P consumer lending, 29%; equity based crowdfunding accounts for around 10%, with various social type lending accounting for the rest.²⁸

Credit unions are often heralded as being a more ethical, fair alternative to mainstream financial institutions. But, as of yet, they are very small in comparison to mainstream banks and building societies especially in England and Wales. There are 462 credit unions in the UK (but 247 of those are in Northern Ireland and Scotland); credit unions have around 1.7 m adult members with 0.25 m juvenile depositors – more than half of these live in N. Ireland and Scotland. Loans outstanding are £1.25 bn (nearly £800 m in NI and Scotland); and shares/ savings are worth £2.6 bn (around £1.8 bn in NI and Scotland).²⁹

Responsible Finance Providers (also known as Community Development Finance Institutions) lent £242 m to 47,500 customers in 2016.³⁰

²² Ibid, Table A5.2 excludes student loans

²³ Ibid, Table A5.2

²⁴ Ibid, Table A5.2

²⁵ The Money Charity, as at March 2017, <http://themoneycharity.org.uk/money-statistics/>

²⁶ FCA Credit Card Study, Interim Report

²⁷ Bank of England, BankStats, April 2017, Table A8.1

²⁸ Peer to Peer (P2P) Financial Association, <http://p2pfa.info/data>

²⁹ Bank of England, Credit Union, Quarterly Statistics, December 2016

³⁰ <http://responsiblefinance.org.uk/policy-research/annual-industry-report/>

Pensions³¹

Huge numbers of UK citizens depend on the success or failure of the private pensions industry to manage their long term savings to produce an income in retirement.

Over 33.5m people are members of employers' pension schemes.³² 11.1 m are active (employee) members; nearly 11 m are receiving a pension from a scheme; while nearly 12 m have 'preserved' pension entitlements.³³

Nearly 12 m are members of personal pension schemes – 7.1 m in employer sponsored personal pension schemes, with 4.8 m with individual arrangements. 7.9m people are contributing to a personal pension.³⁴

Overall, it is estimated that 14.2 m people in the UK are currently contributing to some form of private pension (6.9 m women and 7.3 m men).

The table below shows the proportion of employees and self-employed currently participating in a pension scheme.

Table 1: Pension participation by employment status, % of adults

	Male	Female	All
Employees	60	59	60
Self-employed	17	12	16

Source: Family Resources Survey United Kingdom, 2014/15, June 2016, Pensions, p11

Insurances

The insurance industry is also very important to the financial well-being of UK households. Three-quarters of households have contents insurance and motor insurance, while just under two-thirds (64%) have structural insurance, 12% have mortgage protection insurance, 7% private medical insurance, and 1% income protection insurance. There are 5.7 m investment and savings products (such as investment bonds and endowments) in force.³⁵

³¹ Note there will be an element of double counting in pensions figures due to the fact that many employers schemes use group personal pensions

³² ONS, Occupational Pensions Survey 2015, <http://www.ons.gov.uk/peoplepopulationandcommunity/personalandhouseholdfinances/pensionsavingsandinvestments/bulletins/occupationalpensionschemessurvey/2015#membership-of-occupational-pension-schemes>

³³ Where members are no longer paying into a scheme but retain rights

³⁴ PEN 2, PEN 3 Personal Pensions (including stakeholder pensions): Scheme members contributions annual contributions, HMRC Personal Pension Statistics, September 2016

³⁵ Association of British Insurers, Insurance and Long Term Savings, Key Facts, Households and Types of Products, as at 2014

Key data on the financial sector

UK insurers received around £27 bn in general insurance (motor, property, contents and possessions, accident, health) premiums in 2015.³⁶ The long term or life side of the industry is much bigger. Annual long term insurance net premiums were £116 bn in 2013 premiums (life insurance and annuities-£10bn; individual pensions-£24bn; occupational pensions-£81bn; and income protection and other-£1.5bn).³⁷

Data on wholesale and institutional markets, and payment systems

But the data on retail financial services or even contribution to GDP (see below) do not convey properly: the sheer scale of the UK's financial markets, networks and infrastructures; how critical the financial system is to the functioning of the economy and society; and, in turn, how vulnerable the economy and society is to market failure in the financial system.

The UK's GDP in 2014 was £1.87 trn³⁸ making it the fifth biggest economy in the world. In the same year, employees and self-employed earned nearly £1 trn. The total wealth of UK households was estimated to be around £11 trn in 2014³⁹ – 40% in private pensions, 35% in property, 14% in financial wealth, and 10% in physical wealth. But, to put this in context, the value of all the financial assets owned by banks and other financial institutions was estimated to be worth £20 trillion⁴⁰ (as measured in the National Accounts⁴¹) – in other words, 1,200% of annual GDP. By comparison, the equivalent figure for the USA was just under 500% of GDP, France around 600% of GDP, Japan just under 700%. Even for Switzerland – a country associated with financial services - the figure was around 900% of GDP.

For historical context, the Bank of England estimates that in 1978 financial assets were worth around 200% of GDP, while in 1958 they were worth around 100% of GDP.⁴²

³⁶ table 1: UK general business insurance market statistics - net written premiums (annual and funded business) <https://www.abi.org.uk/Insurance-and-savings/Industry-data/Free-industry-data-downloads>

³⁷ Table 1: UK long -term insurance net premium income (ob & ib) <https://www.abi.org.uk/Insurance-and-savings/Industry-data/Free-industry-data-downloads>

³⁸ ONS, <https://www.ons.gov.uk/economy/grossdomesticproductgdp/datasets/summaryofrecordsuksecondestimateofgdp>

³⁹ ONS, Main results from the Wealth and Assets Survey: July 2012 to June 2014, published December 2015

⁴⁰ Bank of England, Quarterly Bulletin, 2015 Q2, Mapping the UK financial system. Stripping out derivatives, the size of the financial system is £13 trillion.

⁴¹ The National Accounts data includes derivatives

⁴² See Chart 2, Bank of England, Quarterly Bulletin, 2015 Q2, Mapping the UK financial system

Table 2: The UK financial system⁴³

Real Economy		Value 2014 £bn
Household Sector	Assets	£5,900
	Liabilities	£1,700
Corporate Sector	Assets	£1,800
	Liabilities	£4,600
Government	Assets	£700
	Liabilities	£2,100
Financial sector Assets/ Liabilities		
Major UK International Banks		£3,750
Major UK Domestic Banks		£1,160
UK Other Banks		£250
Rest of the World Investment Banks		£1,730
Rest of the World Other Banks		£460
Securitisation Special Purpose Vehicles (SPVs)		£320
Finance Companies		£270
Central Counterparties (CCPs)		£160
Bank of England		£400
Pension Funds		£1,430
Life Insurance companies		£1,610
General Insurance companies		£220
Unit trusts		£700
Exchange traded funds		£90
Private Equity		£90
Investment Trusts		£90
Unauthorised funds		n/a
Total		£13,000⁴⁴

⁴³ Taken from Figure 3, Bank of England Quarterly Bulletin, 2015, Q2, Mapping the UK financial system

⁴⁴ Note that this different to the estimate of £20 trn as measured in the National Accounts data. The difference is primarily due to the exclusion of derivatives.

Key data on the financial sector

In 2014, the total value of payments made through the UK's domestic payments and settlement systems was a staggering £245 trn.⁴⁵ 21 bn transactions worth £75 trn passed through the payment systems alone.⁴⁶ There are 7bn banking transactions and 2.3bn ATM withdrawals per annum.

Around 2,500 institutions are permitted to provide payment services in the UK including those passported into the UK from EEA countries.

Table 3: Breakdown of payment service providers

Type of PSP	Number
Banks and building societies	700
Credit unions	550
Electronic money institutions	100
Payment institutions	1,150
Total	2,500

Source: Financial Conduct Authority (FCA), Payment Services Regulator, Market review into the supply of indirect access to payment systems MR15/1.2 Interim report March 2016, Table 2⁴⁷

Note that payment services providers (PSPs) are not the same as the interbank payment system itself. PSPs are the 'front-end' institution such as banks, building societies, credit unions, payment institutions and electronic money institutions, who provide services to end-users such as consumers and real economy firms. These services include the provision of payment accounts (such as current accounts), the issuing of electronic money, the acquiring of payment transactions, and money remittance.

But, to be able to transfer funds for end-users, PSPs need access to the interbank payment systems. While there are around 2,500 payment services providers, the main payment systems are dominated by a handful of powerful institutions:

- CHAPS – the system which processes high value payments (the scheme and operator is run by a non-profit company, the underlying infrastructure is owned and run by the Bank of England);
- Bacs – the system which processes low value, bulk payments (the scheme and operator owned by a non-profit company, the infrastructure is provided by VocaLink, a commercial operator);

⁴⁵ See Chart 1, Bank of England, Quarterly Bulletin, 2015 Q2, Mapping the UK financial system

⁴⁶ FCA/ Payment Systems Regulator (PSR) , Interim Report Fact Sheet, https://www.psr.org.uk/sites/default/files/media/PDF/MR1522-infrastructure-interim-report-factsheet_0.pdf

⁴⁷ <https://www.psr.org.uk/sites/default/files/media/PDF/MR1512-indirect-access-market-review-interim-report.pdf>

- Faster Payments – the system which processes real time payments (the scheme and operator owned by a non-profit company, the infrastructure is also run by VocaLink); and
- The ATM network – the system which provides access to the ATM network (VocaLink owns all three levels – the infrastructure, the operator, and the scheme itself).

Looking specifically at the UK banking system, the Bank of England estimated its assets were worth around £5 trn or 450% of GDP in 2013, up from 100% in 1975. But, this was projected to rise to £60 trn or 950% of GDP by 2050.⁴⁸

The UK banking system is already much larger as a proportion of GDP than its major economic rivals in the G20. The median ratio of banking assets/ GDP of the G20 countries was around 130% in 2013. This means the gap between the UK ratio and G20 median ratio is around 300%. The gap is set to widen even further to 800% by 2050 raising questions about the risks it poses to the UK’s financial and economic resilience.

In 2013, investment banks generated £10 bn from investment banking and corporate banking services provided to corporate clients.⁴⁹

It is difficult to establish the precise scale of the wider asset management industry. But, it is estimated that the total assets managed in the UK, including overseas assets, is in the region of £6 trillion, the bulk of which is managed for institutional clients such as pension funds.

Table 4: Total assets managed in the UK

Category	Value £
IMA Member Firms	£5-5.4 trn
Discretionary Private Clients	£347 bn
Private Equity Funds	£190 bn
Hedge Funds	£188 bn
UK Commercial Property Managers	£359 bn
Estimated total	@£6 trn

Source: Investment Association (IA), Asset Management in the UK, 2015-16, The Investment Association Annual Survey, Fig 1, p13

It was estimated that the £5.4 trn of institutional assets managed from the UK generated annual management fees of around £17 bn in 2015.⁵⁰

⁴⁸ Bank of England, Quarterly Bulletin 2014 Q4, Why is the UK banking system so big and is that a problem?, Bank of England, Prudential Regulation Authority, p388

⁴⁹ FCA, Wholesale Sector Competition Review, 2014-15, p25

⁵⁰ Investment Association, Annual Asset Management Survey, 2016

Key data on the financial sector

Total assets under management in the UK were worth 320% of UK GDP -up from 144% (end 1993).⁵¹ UK pension funds, insurance companies, and trusts together control over half of the assets of the UK non-bank financial system.⁵² UK pension fund assets are the second largest in the OECD and worth more than 100% of the UK's GDP.

The insurance industry has annual premiums of £220bn and is the largest in Europe, and third largest in the world. The insurance industry holds £1.9 trn of UK and overseas assets spread amongst government bonds, equities, property and cash.⁵³

Economic contribution of the financial sector

The value of the UK's finance and insurance sector's gross value added to the UK economy almost doubled from £69 bn to £137 bn over the period 2000 to 2007 (the eve of the financial crisis). The value had fallen to £124 bn by 2014 but it still constituted 8% of total economy GVA – this is a bigger share than our major economic rivals USA, Japan, Germany and France. London produces £60.5 bn GVA – over 50% of total UK finance and insurance GVA.⁵⁴

According to PWC, banking and financial intermediation activities accounted for 54% of total FS GVA; insurance, reinsurance and pension funding accounts for 31%; with fund management and brokerage accounting for 16%.⁵⁵

1.1 m people are employed in the finance and insurance sectors – 2.2 m if a wider measure is used, see below.

The sector also makes a major contribution to the UK's trade balance. The total UK services industry had a trade balance of £79 bn in 2013. The financial services trade balance made up nearly half of this at £38.3 bn – this represented nearly 3.5% of UK GDP. The fund management and insurance sectors make a significant positive contribution to the UK's balance of payments - the insurance and pensions sector trade balance alone was £20.9 bn.⁵⁶

The banking sector is estimated to have contributed over £24 bn in income tax, national insurance, corporation tax and the bank levy in the tax year 2015/16 – higher than the £23.3 bn raised just before the crisis in 2007/ 08. PAYE receipts were £17.8 bn, higher than the £16.7 bn raised just before the financial crisis in 2007/ 08.

⁵¹ Ibid

⁵² <http://www.bankofengland.co.uk/publications/Pages/news/2014/104.aspx>

⁵³ Table 1: Total long-term and general insurance investment holdings, <https://www.abi.org.uk/Insurance-and-savings/Industry-data/Free-industry-data-downloads>

⁵⁴ Source: ONS, Regional Gross Value Added, December 2014

⁵⁵ PWC, Leaving the EU: Implications for the UK financial services sector, April 2016, see Annex A, p24

⁵⁶ House of Commons Library, Chart 3, Financial Services: contribution to the UK economy Standard Note: SN/EP/06193

Corporation tax receipts are well down from pre-crisis peaks, but this has been offset by the bank levy introduced in 2011.⁵⁷

However, using different measures of tax, it is estimated that the wider financial services industry contributed an estimated £65.9 bn in 2013/14 - 11.5% of total tax take down from 13.9% in 2007 on the eve of the crisis.⁵⁸

Looking at wider measures, total finance and related professional services (including legal services, management consultancy, and legal services) output is estimated to be £190 bn in 2014 – equivalent to 11.8% of GDP. The trade surplus of these sectors was £72 bn – greater than all net exporting industries combined.

A total of 2.2 m are employed in financial and professional services sectors.⁵⁹ Interestingly, although these sectors made up 11.8% of GDP, they accounted for 7.4% of total employment implying greater productivity than other economic sectors.

It is also worth noting that the 2.2 m jobs are not all in London and the South East. 1.2 m are based in other parts of the UK. Of course, it may well be that many of these regional jobs are dependent on City jobs (for example, back office jobs). We cannot tell as we do not have the data. Nevertheless, we must keep in mind that the financial sector is not just the City. This will be an important factor when policymakers consider the respective roles of domestic and export-orientated financial services in a post-Brexit world.

In terms of profitability, the UK's financial sector used to account for around 3% of total private sector profitability in the mid-1950s – mid 1980s, trading mostly within the range of 0-6%. However, this shot up to between 10-15% by the late 1980s. The share peaked at just under 23% in 2009, falling to around 15% in 2012.⁶⁰ The share is volatile but the upward trend has been unmistakable.

The international nature of the UK financial system

Along with the sheer scale of the UK financial system, the amount of international business conducted in the UK and level of trade with the rest of the world including the EU is a defining feature. This is very relevant for the debate around Brexit.

⁵⁷ HMRC, Pay-as-You-Earn and Corporation Tax Receipts from the banking sector, August 2016

⁵⁸ <http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Pages/Total-tax-contribution-of-UK-financial-services-seventh-edition.aspx>

⁵⁹ Key facts about UK financial and related professional services, The City UK, March 2016

⁶⁰ Don't bank on it: the financialisation of the UK economy, IPPR, December 2012, Fig 3.3, gross operating surplus of private financial corporations, share of total %, http://www.ippr.org/files/images/media/files/publication/2012/12/dont-bank-on-it-financialisation_Dec2012_10058.pdf?noredirect=1

Key data on the financial sector

There are 150 deposit-taking foreign branches and 98 deposit-taking foreign subsidiaries⁶¹ from 56 different countries based in the UK. Foreign banks make up half of UK banking sector assets. Foreign branches account for 30% of UK bank assets and one-third of interbank lending. Nearly 20% of all global banking activity is booked in London. In 2014, the foreign assets and liabilities of UK resident banks were worth more than 350% of UK GDP – this was four times the median figure for OECD countries.⁶²

The UK enjoys a pre-eminent position in the key global financial markets such as foreign exchange and derivatives. The sums involved are huge. According to the Bank of England, 40% of foreign exchange trading volume (around £600 bn of foreign exchange is traded in London every day), and 70% of trading in international bonds takes place in London.⁶³ As the table below shows, nearly 40% of foreign exchange derivatives and OTC interest rate derivatives by value take place in the UK. More international banking activity is undertaken in London than anywhere else in the world.⁶⁴ The top ten global investment banks with operations in the UK have trading assets worth more than £5 trillion.⁶⁵ The value of European derivatives outstanding is €200 trn- the bulk of which are traded in UK.⁶⁶ We can see from this table how important London became as a global financial centre.

Table 5: Global derivatives trading

OTC Foreign Exchange derivatives, turnover, daily averages \$bns

	1995	1998	2001	2004	2007	2010	2013	2016
UK	479	685	542	835	1,483	1,854	2,726	2,426
UK % of global total	29%	33%	32%	32%	35%	37%	41%	37%
US	266	383	273	499	745	904	1,263	1,272
US % of global total	16%	18%	16%	19%	17%	18%	19%	19%
All reporting countries	1,633	2,099	1,705	2,608	4,281	5,043	6,671	6,546

Source: Bank for International Settlements (BIS), <http://stats.bis.org/statx/srs/table/d11.2>

⁶¹ There is an important distinction between a subsidiary and a branch. A subsidiary of an overseas bank is a separate entity from its parent and is therefore considered to be a UK entity. A branch of an overseas bank is still part of the parent entity.

⁶² Bank of England, Quarterly Bulletin 2014 Q4, Why is the UK banking system so big and is that a problem?, Bank of England, Prudential Regulation Authority, p386

⁶³ Investment banking: linkages to the real economy and the financial system, Bank of England, Quarterly Bulletin Q1 2015

⁶⁴ <http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech821.pdf>

⁶⁵ Investment banking: linkages to the real economy and the financial system, Bank of England, Quarterly Bulletin Q1 2015, Trading assets are securities, commodities and derivatives held for trading. .

⁶⁶ to put this in context, the combined market capitalisation of European stockmarkets is Euro 12 trn

OTC single currency interest rate derivatives, turnover, daily averages \$bns

	1995	1998	2001	2004	2007	2010	2013	2016
UK	59	123	238	563	957	1,235	1,348	1,180
UK % of total	28%	36%	35%	42%	44%	47%	49%	39%
US	32	58	116	317	525	642	628	1,241
US % of total	15%	17%	17%	24%	24%	24%	23%	41%
All reporting countries	209	344	676	1,330	2,173	2,649	2,702	3,028

Source: Bank for International Settlements (BIS), <http://stats.bis.org/statx/srs/table/d12.2>

The UK asset management industry is the second largest in the world. The sector accounts for approximately 37% of total European assets under management (AUM). In total, £2.2 trn of assets (38% of the total) managed in the UK were managed on behalf of overseas clients - £1.2 trn for European clients, £310 bn for US clients, and £660 bn on behalf of rest of the world clients.⁶⁷

58% of asset management firms in London are overseas firms.⁶⁸ Interestingly, UK owned asset managers now account for 42% of total assets under management, down from 60% ten years ago. In contrast, the proportion of assets managed in the UK for US parent companies has risen to 47% up from 28% over the same period (the UK is attractive as a base for US asset managers partly because of the access it gives to the EU markets).

It is not surprising that this sector has taken centre stage in the discussions about Brexit. The terms of access to EU markets could have a significant effect on the attractiveness of the UK as a base for asset management and therefore the revenue generated.

Interestingly, £775 bn of assets domiciled overseas is actually managed from London. The main overseas locations are Dublin, Luxembourg, Channel Islands and the Cayman Islands.⁶⁹ Three-quarters of European hedge funds are managed in London.

65% of Fortune 500 companies have their European headquarters in London, while London is one of the top two centres for listing companies on the stockmarkets (IPOs).

The UK is a bigger net exporter of financial services than its major economic rivals – US, Japan, Germany, France, Italy, and Canada.⁷⁰

⁶⁷ IA Annual Asset Management Survey, 2015-16

⁶⁸ Ibid

⁶⁹ Ibid

⁷⁰ Cournède, B. and O. Denk (2015), "Finance and economic growth in OECD and G20 countries", OECD Economics Department Working Papers, No. 1223, OECD Publishing, Paris.

Key data on the financial sector

Financial, insurance and pension services are the two areas in which the UK has the greatest revealed comparative advantage relative to its G7 rivals.⁷¹ One-third (33%) of all exports of financial, insurance and pensions services are exported to the EU.⁷²

Passporting rights

One of the biggest concerns of the UK financial services industry is that firms will lose the valuable Single Market Passport. Firms that hold a passport (issued by the FCA and PRA) and with operations established in the UK are able to trade freely across the whole EU⁷³ without having to become authorised in the other Member States they might want to conduct business in.

The table below sets out the numbers of firms holding passports under the various EU Single Market Directives,⁷⁴ the total number of passports held by UK firms wanting to trade in the rest of the EU (Outbound), and EU firms wanting to do business in the UK and other EU Member States (Inbound). In addition to firms exercising passport rights, the Single Market legislation allows for certain financial products to obtain passports.

Table 6: Financial firms holding EU passports

	Outbound	Inbound	Total
Number of firms using passports	5,476	8,008	13,404
Total number of passports	336,421	23,532	359,953

Note there is a large number of firms holding inbound passports. This is attributed to the attractiveness of the UK as a financial centre for overseas firms wanting to do business in the rest of the EU and to the reputation of the UK system of financial regulation and financial regulators. This, of course, may change post-Brexit.

<http://dx.doi.org/10.1787/5js04v8z0m38-en>, Fig 11: Ratio of domestic consumption to domestic production of financial activities

⁷¹ Revealed comparative advantage (RCA) measures how competitive industries are internationally – industries with high positive RCA measures represent a disproportionately high share of UK exports, see HM Treasury Analysis: the Long Term Economic Impact of EU Membership and the Alternatives, Chart 1A: UK revealed comparative advantage relative to G7 countries (2014), April 2016

⁷² HM Treasury Analysis: the Long Term Economic Impact of EU Membership and the Alternatives, Box 1D: Impact of the EU on the UK's financial services industry,

⁷³ Certain directives also allow for trading in EEA states

⁷⁴ The key EU directives under which passporting rights are available are: Alternative Investment Funds Managers Directive (AIFMD), Capital Requirements Directive (CRD), Electronic Money Directive (EMD), Solvency II Directive, Insurance Mediation Directive (IMD), Markets in Financial Instruments Directive (MiFID), Mortgage Credit Directive (MCD), Undertaking in Collective Investment, UCITS Directive, Payment Services Directive (PSD)

Fintech

As well as being one of the leading global centres for more established financial services such as investment banking, asset management and insurance, the UK is a leader in the new fintech industries – as the financial sector harnesses new technologies.

According to the trade association for fintech,⁷⁵ the sector is fast growing with the UK the leading centre after the USA. The UK fintech sector is now worth £20 bn in annual revenues to the UK, employs 135,000 people and attracted 42% of all European fintech investment in 2014. The UK is Europe’s leading fintech hub and saw investment increase from \$264 m in 2013 to \$623m in 2014. However, the UK still has some way to go before it attracts the same level of investment as the USA. ‘Silicon Valley’ remains dominant in absolute terms for attracting fintech investment at over \$2 bn. This is greater than the entire level of fintech investment in Europe (\$1.48 bn).⁷⁶

However, it should be pointed out that other research produced for HMT suggests the revenue is much smaller – although even with these more conservative estimates, the UK is a leading centre for fintech.

Table 7: Comparative size of UK fintech sector

Region	Market size	Investment	Staff
UK	£6.6 bn	£524 m	61,000
New York	£5.6 bn	£1.4 bn	57,000
California	£4.7 bn	£3.6 bn	74,000
Germany	£1.8 bn	£388 m	13,000

Source: UK Fintech: On the cutting edge, an evaluation of the international fintech sector, E&Y for HM Treasury, 2015

Perhaps not surprisingly London was rated by financial market participants as being a leading, if not the leading, global financial centre.⁷⁷

So, it is clear that the City is critically important to the UK. But we cannot get a true picture of its overall value to the UK unless we look also at the other side the ‘balance sheet’ – the costs. We now turn to this.

⁷⁵ <http://innovatefinance.com/our-voice/innovate-finance-manifesto-uk-2020>

⁷⁶ Ibid

⁷⁷ London is ranked number 1 in the Global Financial Centres Index, September 2015, http://www.longfinance.net/images/GFCI18_23Sep2015.pdf

Section five

The economic and social audit framework

The UK’s financial markets may be huge and make an impressive contribution to the UK economy. But metrics such as the size of markets or volume of transactions tell us little about how well those markets meet the needs of households and the real economy. To judge whether financial markets are working for households and the real economy, we must consider the following questions:

- How good is the conduct in the City;
- How economically and socially useful are financial market activities;
- Do financial markets create externality or social costs; and
- Do financial markets present a risk to financial stability and wider economic resilience?

The table below sets out the specific issues we considered under each of four main audit headings.

Table 8: Outline of the economic and social audit framework

Theme	Issues covered
Conduct of business, culture and integrity (see A)	The main issues covered here include: How good is the conduct in the City: do financial institutions and intermediaries act with integrity, do they treat clients fairly? What are the costs associated with misconduct and misselling? Do users have trust and confidence in the financial system?
Economic and social utility (see B)	To assess how economically and socially useful financial market activities are, we consider: Are financial market activities geared to meet the needs of households and the real economy? Are financial markets competitive and efficient, do financial institutions and intermediaries add or extract value? Do financial markets allocate resources effectively to the most productive uses, and encourage sustainable economic growth?

Negative externalities and social costs
(see C)

As well as creating positive benefits, financial markets should also not create negative externalities or social costs. The financial crisis showed that the harmful negative effects of financial market activities are not necessarily contained within the financial system. The type of negative externalities can include:

Direct costs of the financial crisis;

The impact on the wider economy and productivity;

Effects on economic inequality including the creation of asset price bubbles which exacerbate existing economic inequality (both intra and inter-generational) and financial and social exclusion;

Failures of institutional investment managers to exercise due diligence and stewardship) which can fail to constrain damage to the environment; and

Tax avoidance.

Financial stability and resilience
(see D)

In the aftermath of the financial crisis, when thinking about financial system resilience there are three very important questions to consider:

Has the risk of new financial crisis been mitigated?

Has the risk of contagion from the financial system to the wider economy been reduced?

Linked to this, is the economy more resilient to financial shocks and more able to continue to function in the event of the financial system seizing up (for example, would firms and households be able to transact and have access to finance)?

A) Costs associated with poor conduct of business and culture, impact on confidences and trust

We define good conduct of business and culture as: markets and services which are transparent and operate with integrity; and a culture which encourages firms and intermediaries to treat customers fairly and manages conflicts of interest. To assess this we consider:

- What are the costs associated with misconduct and misselling?
- What has the impact been on trust and confidence in the financial system?

Below we summarise the key examples of misselling and misconduct we are aware of along with estimates of costs. Note that, while we are able to estimate with reasonable accuracy the costs associated with retail misselling scandals, it is not

possible to arrive at a single figure for total costs borne by UK financial institutions relating to all conduct of business failures. This is because much of the costs has been imposed in relation to non-UK financial activities and it has not been possible to allocate the costs accurately enough between UK and non-UK financial operations – although it should be noted that in many cases, even if the activities occurred outside the UK, UK shareholders would ultimately bear the costs.

Retail misselling

There have been a number of high profile retail misselling scandals affecting ordinary consumers. According to our tally, the total amount of detriment attributable to well-known misselling scandals in UK retail financial services over the past three decades or so is now over £45 bn⁷⁸ - or equivalent to £1.5bn per annum. This is important because, as we explain later, although this is a huge figure it is much smaller than the welfare losses created through market inefficiency, value extraction, and externality costs. One of the recurring themes throughout this report is that, while consumer groups have been very effective at exposing ‘retail’ financial scandals and holding firms to account, the much bigger market failures have not received the same attention.

Table 9: Key retail misselling cases

Misselling case	Estimated cost of redress	£ m
Payment protection insurance	30,000 ⁷⁹	
Personal pensions	11,800	
Mortgage endowments	2,700	
Credit card protection insurance	1,300	
Split capital investment trusts	144	

Source: FCA reports, FIC tally

In addition to redress costs arising from misselling, the Financial Services Compensation Scheme (FSCS) has paid out £26 bn in compensation to 4.5 m customers of firms that have gone bust since 2001.⁸⁰

Institutional and corporate misselling

But, detriment has not been restricted to retail consumers. It has occurred in dealings with real economy firms, local authorities, and pension fund trustees. This is an important point. Historically, clients such as SMEs and pension fund trustees have

⁷⁸ This includes misselling of personal pensions, mortgage endowments, PPI, split caps, and interest rate hedging products.

⁷⁹ Includes redress paid and provisions

⁸⁰ Mind the Gap: Restoring Consumer Trust in Financial Services, FSCS, Design Technology, November 2015, <http://www.fscs.org.uk/globalassets/press-releases/20151111-fscs-trust-white-paper-final.pdf>

been considered as ‘sophisticated’ by financial regulators and deserving of less consumer protection. However, there is no reason to expect that the individuals making decisions on behalf of SMEs, pension schemes or local authorities are any more equipped to understand complex financial services or manage the conflicts of interests involved when financial intermediaries are incentivised by large fees. Indeed, given the sums of money involved (for example, in the employers’ pension fund sector) the financial impact of a bad decision can be much greater than retail misselling.

Some of the key examples of poor conduct involving commercial and other non-retail clients include:

- Provisions for misselling of interest rate hedging products to SMEs now amount to £3.8 bn.⁸¹
- Investment banks sold around £5 bn of LOBOs⁸² to local councils between 2003 and 2012. 80% (£4 bn) of these were sold during the four years in the run up to the financial crisis (2004-2007). These are complex financial structures that blended conventional loans with derivatives. This form of borrowing when taken out may have seemed cheap compared to borrowing direct from HM Treasury. But there are concerns that local authority finance staff did not understand the derivatives risks associated with these LOBO loans with the result that they are now paying huge amounts to service the loans. This has a real impact on local communities as the loan payments eat into the resources available for local services. The high commissions earned by influential financial intermediaries may have exacerbated existing conflicts of interest and led to unsophisticated local authority officials being badly advised.⁸³
- Concerns have been raised that local government pension schemes have been subject to misleading advice by investment consultants resulting in poor investment decisions being made and schemes being overcharged for advice. Ultimately these costs are borne by council tax payers. A recent report has found that some investment consultants have been using misleading methods to promote the take up of alternative investment products (such as hedge funds and private equity funds).⁸⁴ The performance benchmarks used to promote alternative investments were found to have been set artificially low. This flattered the performance of alternative investments - high charging alternative investments funds have produced poor performance compared to more conventional asset classes. Moreover, as these funds are usually sold with performance related fees,

⁸¹ <http://www.congruentfinancialpartners.com/factsheets-and-faqs/banks-provisions-for-irhp-redress/>

⁸² LOBO stands for Lender Option Borrower Option

⁸³ <http://lada.debtresistance.uk/debt-resistance-uk-investigation/who-are-the-major-borrowers-from-the-banks/>

⁸⁴ Misselling of alternatives by investment consultants? A review of methods used to promote alternatives and dress-up performance <http://www.clerus.co.uk/wp-content/uploads/2014/10/Mis-selling-of-Alternative-Investment-by-Investment-Consultants-A-Review-of-Methods-used-to-Promote-Alternatives-and-Dress-up-Performance.pdf>

artificially inflating the relative performance can generate excess fees for investment managers. The report found that local government schemes valued at £20 bn (out of a total local government pension scheme universe of around £200 bn) were benchmarked inappropriately. The overall performance of local government schemes affected has been reduced by £5.1 bn (in current prices) by these practices. This figure excludes the excess performance fees paid to alternative investment managers. Given that total UK pension fund assets are valued at more than £1 trillion, if these practices are repeated across the industry the scale of detriment would be very large.

Capital and wholesale markets

Successful prosecutions of market abuse and insider dealing in the UK are surprisingly uncommon given the size of the UK financial markets. Since 2005, there have been just seven criminal convictions in the UK for insider dealing with five more for other forms of market abuse. In the US, there were 534 over the same period.⁸⁵ The US stockmarket (valued at \$12 trillion) is, of course, much larger than the UK market (\$2.4 trillion) so a larger number of prosecutions is to be expected. But, comparative market size does not explain the different numbers of prosecutions. The US market is five times larger than the UK market. But the number of successful prosecutions in the US is 44 times greater than in the UK.

Turning to the wholesale markets, the costs associated with the manipulating the London Interbank rate (Libor) are so far estimated to have cost banks \$6 bn in fines on a global basis possibly rising to \$22 bn⁸⁶ (note it has not been possible to estimate accurately the losses incurred by clients yet – although one estimate put this at potentially \$160 bn on global basis⁸⁷). Fines for foreign exchange manipulation may be even greater⁸⁸.

Wider conduct costs

The global cost of conduct failure borne by banks due to misselling and other conduct issues such as market manipulation, insider trading, and money laundering is estimated to be over £200 bn (including provisions for redress as yet unpaid). Note this is not all due to UK banking activities. However, ultimately a large share of the costs are borne by UK consumers/ shareholders.⁸⁹

⁸⁵ Insider dealing and market abuse: The UK's record on enforcement Paul Barnes, Professor of Fraud Risk Management Nottingham Business School, http://www.paulbarnes.org.uk/images/Z_IMAGES/Ijlcj.pdf

⁸⁶ <http://www.ft.com/cms/s/0/0231ace4-cc1d-11e1-839a-00144feabdc0.html#axzz38lwHsCPu>

⁸⁷ <http://www.businessweek.com/articles/2013-06-27/calculating-the-cost-of-the-libor-scandal-to-investors>

⁸⁸ <http://www.risk.net/risk-magazine/feature/2334181/costs-of-forex-manipulation-could-be-worse-than-libor>

⁸⁹ This is based on costs borne to date plus provisions over the 5 year period 2010-14 CCP Research Foundation, Conduct Costs project, <http://conductcosts.ccpresearchfoundation.com/conduct-costs-results>

Research by academics highlights how much poor conduct has cost the banks. The four major UK banks – Barclays, HSBC, Lloyds Banking Group, and RBS – made a total of £26 bn provisions for redress in 2014 with a further £19.9 bn for the first half of 2015.⁹⁰ The table below shows the total conduct costs (on a rolling five year basis) for the major UK banks from 2008-2014. The estimate for 2010-14 was £55.74 bn – nearly double the 2008-12 rolling total.⁹¹

Table 10: Conduct costs for UK banks

	Total costs, 2010-14, £bn	Provisions, Dec 2014, £bn	Grand Total, 2010- 14, £bn	Grand Total, 2009- 13, £bn	Grand Total, 2008- 12, £bn
Lloyds Banking Group	12.24	3.38	15.62	12.72	9.24
Barclays	8	4.59	12.59	7.89	5.06
RBS	6.79	4.11	10.9	8.47	4.24
HSBC	6.39	2.29	8.68	7.21	6.25
Santander	3.87	3.07	6.94	3.57	4.14
Standard Chartered	0.96	0.05	1.01	0.76	0.75
Total	38.25	17.49	55.74	40.62	29.68

Source: CCP Research Foundation⁹²

An interesting point is that the total cost of fines and redress for misselling paid by the major banks over the period end 2009-2014 was around £30 bn – this was approximately equal to the amount of private capital they raised over the same period.⁹³

The realisation is dawning that misselling and poor conduct not only harms those consumers directly affected, it harms shareholders and the real economy – paying out redress reduces the funds available for lending to households and real economy.

Costs associated with conflicts of interest

Clients can be harmed by not just by outright misselling or misconduct but by failure to manage conflicts of interest inherent in the financial system.

As we go onto explain, investors are being penalised by unnecessarily high levels of trading (overtrading) – a function of market inefficiency. But they are also penalised by the failure of market agents to execute the best deal when trading on their behalf.

⁹⁰ <http://conductcosts.ccpresearchfoundation.com/conduct-costs-results>

⁹¹ Note: there have been further provisions

⁹² <http://conductcosts.ccpresearchfoundation.com/conduct-costs-results>

⁹³ Bank of England,

<http://www.bankofengland.co.uk/publications/Documents/fsr/2015/fsr37sec5.pdf>

The economic and social audit framework

The sheer scale of the assets involved in the financial system means that even seemingly tiny improvements can result in huge welfare gains for investors.

Regulatory interventions to tackle the perceived conflicts of interest between brokers, investment managers and pension funds by introducing greater disclosure and transparency do not seem to have had much success. Academic research found that after disclosure measures were introduced, commission rates did indeed fall from 13.1 basis points to 11 basis points⁹⁴ over the period 2005-2008. But the actual amount of commission payments increased over the same period by a factor of 2.5 times due to an increase in the portfolio churn rate from on average 28% to 73%.⁹⁵

In a recent analysis of the asset management industry, the FCA estimates that a 1 basis point (ie. 1/100th of one percent) reduction in trading costs would represent a £37.5bn improvement in client returns over 30 years. This is not a very ambitious target improvement and is a very conservative estimate of the welfare gain that could be achieved if markets were more efficient.⁹⁶

Evidence of potentially serious conflicts of interest in the investment supply chain has been found by the FCA. It recently published a review of how firms use dealing commission - the charges paid by consumers for executing trades and external research, worth around £3 bn a year. The FCA reviewed the behaviours of 17 investment managers and 13 brokers and found that only two investment managers operated at the level the regulator expected in terms of assessing value for money for clients and managing conflicts of interest.⁹⁷

More generally, in a recent review of wholesale markets,⁹⁸ the FCA found a number of potentially serious problems around lack of transparency and conflicts of interest:

- Low levels of transparency - value for money for investment and corporate banking services can be difficult for clients to assess. Quality and costs are often difficult to predict in advance. This lack of transparency also has an impact on effective competition.
- Bundling and cross-selling of services – the bundling of investment and corporate banking services can make it more difficult for clients to assess whether they are getting value for money when paying for a series of services over time. This bundling can also act as a barrier to entry for better value providers.
- Principal-agent issues – the nature of investment banking means that investment banks can act as agents for clients in the market and trade on their own behalf in

⁹⁴ A basis point is one one-hundredth of a percentage point. So, 13 basis points is 0.13%, 11 basis points is 0.11%.

⁹⁵ Does transparency overcome conflicts of interest? Evidence from investment managers and their brokers, Mark Abrahamson Said Business School, Oxford University; Tim Jenkinson Said Business School, Oxford University and CEPR; Miguel Sousa Said Business School, Oxford University and Economics and Management School, University of Porto, March 2012

⁹⁶ <http://www.fca.org.uk/your-fca/documents/thematic-reviews/tr14-13>

⁹⁷ <http://www.fca.org.uk/news/fca-steps-up-focus-on-fair-use-of-client-dealing-commission>

⁹⁸ FCA, Wholesale Competition Review, February 2015

the market. The conflict of interest inherent in this type of relationship means there is a risk that the investment bank will not act in the client's best interest. The data required to monitor whether the investment bank is acting with integrity and not exploiting conflicts of interest is onerous and means that clients may not be in a position to protect their own interests.

It is important to note that misselling and misconduct not only imposes direct costs on consumers (and firms and shareholders as redress has to be paid), it can have much wider detrimental effects on the real economy. As mentioned, redress costs can reduce the capacity for banks to lend to the real economy. But, the impact on consumer and firm's behaviours must also be considered. Low levels of trust and confidence can make consumers and firms reluctant to deal with the financial sector undermining willingness to save and invest.

Impact on confidence and trust

There are less tangible costs to consider such as the impact of misselling and poor conduct on confidence and trust in financial markets. Confidence and trust is a prerequisite for effective financial markets. If consumers and firms do not have confidence and trust they will not engage with financial markets which can create wider negative economic and social costs.

A recent survey undertaken by the Bank of England⁹⁹ found that 75% of small businesses remained reluctant to borrow from banks. Although economic conditions undoubtedly had a major impact, intelligence from the Bank of England's Agents suggests that it was also partly due to distrust of banks among smaller companies.

Low levels of consumer confidence and trust in financial services are well documented. Financial services is one of the least trusted industries globally with levels of trust in the UK much lower than the EU and rest of the world.¹⁰⁰

The European Commission also produces a major biennial EU wide survey on consumer attitudes to 52 consumer sectors covering all EU member states.¹⁰¹ The private pensions, and securities sectors are consistently poor performers each year the study is conducted and in every EU country covered. In the UK the investment, pensions, and securities sector scored came third from bottom in the most recent survey – just above train services and real estate services.

⁹⁹ Bank of England, SME Finance Monitor, 2015 Q1

¹⁰⁰ The Edelman Insights survey ranks nine major sectors – technology, consumer electronics, car industry, food, telecoms, pharmaceutical industry, energy, financial services, and media. 54% of consumers say they trust financial services – second lowest only to the media. Only 39% of informed UK consumers surveyed said they trusted the industry (36% of the general population). Source: <http://www.edelman.com/insights/intellectual-property/2015-edelman-trust-barometer/trust-across-industries/financial-services-path-to-building-trust/>

¹⁰¹ EU Consumer Market Scoreboard 2016 edition, p185

http://ec.europa.eu/consumers/consumer_evidence/consumer_scoreboards/12_edition/index_en.htm

The economic and social audit framework

Recent research confirms the low levels of confidence and trust have in the leaders of financial firms.¹⁰² 64% of consumers surveyed said they had little or no confidence that directors and CEOs of financial firms intend to treat customers fairly – only 26% said they had some or complete confidence. This is of real concern given the importance the Financial Conduct Authority places on the fair treatment of customers.¹⁰³ The same research highlights the anger consumers feel towards the industry leaders. When asked what the main causes of mistrust, 69% said that the pay and bonuses of directors was excessive, 59% said that the public paid the price of the credit crunch while directors got off free.

Low levels of confidence and trust don't just affect individual households, it can have wider public policy consequences. If consumers are deterred from saving for a pension this can impose costs on future generations of taxpayers. Moreover, failures in one part of the financial system can contribute to failures in another. The lack of trust and confidence in pensions increases the perceived attractiveness of property as an investment. This can then add fuel to property price bubbles – most recently through the growth in buy-to-let investment.

B) The economic and social utility of the city

To assess how economically and socially useful financial market activities are, we consider:

- Are financial market activities geared to meet the needs of households and the real economy?
 - Are financial markets truly competitive and efficient, do financial institutions and intermediaries add or extract value, are financial markets truly innovative – from the perspective of end-users?
 - Do financial markets allocate resources effectively to the most productive uses, and encourage sustainable economic growth?
-

Above, we outlined the costs associated with poor conduct. Of course, misselling and poor conduct are forms of market failure and the associated costs could be included in this section. But, here we wanted to consider a more fundamental question about the economic and social utility of the City.

¹⁰² See 3R Insights, Leadership crisis - consumer perceptions of CEOs and directors of financial services firms, December 2016, <http://3r-insights.com/>

¹⁰³ See for example the six consumer outcomes the FCA says that firms should strive to achieve to ensure fair treatment of customers. These remain core to what the regulator expects of firms <https://www.fca.org.uk/firms/fair-treatment-customers>

If financial markets are to be considered economically and socially useful, markets should produce the following tangible benefits for households and the real economy:

- Financial transactions which are the lifeblood of the real economy happen securely and efficiently, consumers and firms are able to access the banking system.
- Capital gets from where it is, to where it is needed in the most economically productive and socially useful way. For example, firms in the real economy are able to attract long term, patient capital for innovation or research and development or governments are able to fund public services and infrastructure cost efficiently. In turn, this asset allocation function should allow households to invest for future needs such as retirement.
- Households and real economy firms are able to access credit that suits their needs.
- Financial market activities should promote economic resilience through the diversification and management of risk, not create risks for the real economy.
- Insurance activities allow households and firms to manage risk and protect against shocks.

In meeting those needs, markets should be competitive, efficient and innovative from the user perspective. This is a critical point. There is no question that there is fierce *competitive activity* in financial markets. But that is not the same as competition that works in the interests of end-users. Similarly, there is a huge amount of new product and service development in retail, institutional and wholesale financial markets. But that is not the same as innovation that works in the interests of the end-users. Indeed, it would seem that much ‘innovation’ in financial markets was developed to deal with risks and problems created by a previous set of innovations. In other words, there is an *innovation illusion*.

Below, we provide examples of market failure and significant risks in the financial system. When looking at this data, it is worth keeping in mind that we estimate that the annual loss attributable to ALL the high profile retail misselling cases (pensions, endowments, PPI etc.) is equivalent to £45 bn over 30 years or £1.5 bn per annum.

The ‘types’ of welfare loss, market failure and risks are grouped into the following categories:

- value extraction/ market inefficiency costs: resulting from intermediaries in the supply chain extracting or destroying rather than enhancing customer value through high charges/ poor value, conflicts of interest, unnecessary layers in the supply chain, or more generally markets operating inefficiently;
- financial intermediation losses/ misallocation of resources: this includes markets behaving ‘irrationally’ or the financial intermediation process misallocating resources away from economically and socially useful activities.

As we can see, the estimated costs of failure and market inefficiencies are staggering. NB: these estimates are not cumulative as there will be a degree of overlap.

Does the City meet the needs of real economy?

It is difficult to establish with certainty what share of financial market activities are geared towards meeting the needs of the real economy rather than other parts of the financial system. But, one proxy for this might be to look at the revenues investment banks generate from providing services to the financial system and from providing services to the real economy.

The global nature of investment banking operations can make it difficult to separate out the revenue attributable just to UK operations. However, the Bank of England estimated the revenues of the top 10 largest global investment banks in 2013 which provides an indication of the scale and source of revenues.

Table 11: Investment bank revenues

Category	Revenue, \$bn	Share of revenue from providing services to financial system	Share of revenue from providing services to the real economy
Underwriting and advisory			
Mergers and acquisitions	7	15%	85%
Debt capital markets	20.8	44%	56%
Equity capital markets	6.8	23%	77%
Sales and trading			
Prime brokerage	10	100%	0%
Equity derivatives	14	80%	20%
Cash equities	7	n/a	n/a
Rates	29	92%	8%
Securitisations	10.5	100%	0%
Commodities trading	4.5	n/a	n/a
TOTAL	140	75%	25%

Source: estimates from Investment banking: linkages to the real economy and the financial system, Bank of England, Quarterly Bulletin Q1 2015, data as at 2013

As the table shows, the top 10 global investment banks made \$140bn (equivalent to approx. £88bn)¹⁰⁴ in 2013. What is interesting is that just one quarter of these revenues were generated by providing services direct to the real economy. The bulk of the revenues were made from sales and trading activities associated with providing services to the rest of the financial system.

¹⁰⁴ \$1.59 to £1 rate used for conversion

Bank lending to the real economy

Just one half of UK bank assets are in the form of loans to households and real economy firms. For the largest foreign bank subsidiaries, under 10% of assets are loans to non-bank customers. So, these banks have not been lending to the real economy but to other institutions within the financial system.

Other data supports the view that the system of financial intermediation may be failing at one of its primary purposes – to allocate resources to economically useful, real economy activities. Bank loans outstanding to UK non-financial corporations fell by nearly 30% from Q4 2008 to end 2013.¹⁰⁵

Analysis of total lending by UK banks shows just how small the proportion of loans outstanding are to the real economy firms and how much is lending to existing assets (such as property) and other parts of the financial system.

Table 12: UK bank lending to various sectors

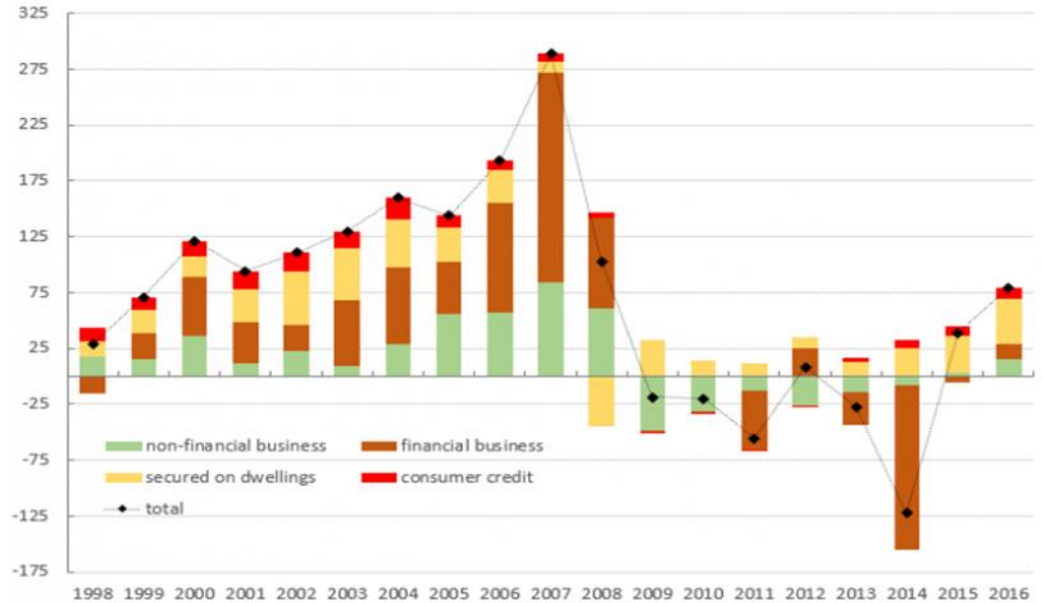
Category	Loans outstanding, £bn
Mortgages	1,288
Commercial Property	196
Personal loans (inc credit cards)	105
Financial sector	461
Public sector	51
Non-financial business ('real economy' firms)	185
Total	2,100

Source: Positive Money, <http://positivemoney.org/issues/recessions-crisis/>, data as at end 2013,

Recent analysis from the TUC of the latest Bank of England data shows that there has been some improvement. Overall lending was positive across the board. Financial corporations, households and businesses (chart below) all saw increases in the amount lent by banks. But as the chart below sets out, lending is still weak compared to the pre- crisis period. Moreover, businesses (the green bar in the chart) are faring worst, with lending increasing by just £15bn over the last year.

¹⁰⁵ Financial Stability Board, McKinsey – Economist, p4, Special report on International Banking, May 10th 2014

Bank lending to all sectors, annual change £ billion¹⁰⁶



Much of the imbalance in loans outstanding can be explained by the fact that very little of the £1 trn of loans (and therefore money) created in the run up to the crisis (between 2000 and 2007) went to real economy firms.¹⁰⁷ Around 31% went to residential property – this had the effect of pushing up house prices faster than wages; 20% went into commercial property; 8% went into credit cards and personal loans; 32% went to the financial sector, which then was rocked by the financial crisis with devastating consequences for the real economy and society; just 8% went to businesses outside the real economy.

Of course, it would be wrong to automatically conclude that these activities have no economic or social utility. As mentioned, many retail financial services make use of investment banking activities to manufacture products such as mortgages. However, it does appear that a sizeable share of these revenues are generated from speculative or proprietary activities which arguably have little economic or social utility – and indeed can introduce major risks into the financial system as we saw in 2007/08.

Moreover, financial sector profits have taken an increasingly large share of private sector profits. The question is: are these profits being made on the back of activities that are not economically or socially useful or do these activities generate much needed tax revenue regardless of the more obvious direct benefit for the real economy?

¹⁰⁶ <http://touchstoneblog.org.uk/2017/02/bank-lending-into-economy-still-very-weak-and-still-dominated-by-property/>

¹⁰⁷ Source: Positive Money, Financial Crises and recessions, <http://positivemoney.org/issues/recessions-crisis/>

This is an area which needs further work. It may well be the case that we are exposing the UK to systemic risk by allowing domestic and foreign financial institutions to undertake activities which have no economic utility for ordinary households or the real economy.

Value extraction/ market inefficiency

As explained previously, one of the primary functions of the financial markets is to gather resources from savers and investors and then allocate those resources to the real economy to fund new enterprises or capital investment. In turn, this is supposed to generate returns for savers and investors to fund retirement and other future financial needs.

So, an efficient system of resource allocation and asset management is critical to the functioning of the real economy. There is a huge, complex system of investment banks, brokers, analysts, fund managers, information providers, administrators, custodians, and intermediaries involved in this critical role.

But how do we judge whether this system is functioning well? Competition between investment managers and other investors is a zero sum game – that is, they constitute the market and if one fund manager outperforms against a benchmark then another will by definition have underperformed. The greater the level of activity in markets, the higher the trading costs, which reduces the net returns delivered to investors or reduces the amount of investor capital that is channelled to real economy firms. These activities can only add value for investors and the real economy if the aggregate impact is to improve the business performance of companies they invest in, encourage more sustainable economic growth, and in doing so generate improved returns for investors.

We use three key tests to assess how well the financial system serves the wider economy, firms, and households. These are:

- Do financial market activities and the decisions made by actors in the financial markets allocate resources to the most productive uses and contribute to sustainable economic growth;
- How effective are these actors at making asset allocation and specific investment decisions which add value for investors; and
- In terms of costs, how efficiently are these activities undertaken? Unless the services and advice provided by various intermediaries add value for investors in the form of better risk adjusted investment returns, by definition the costs levied will extract or actually destroy value.¹⁰⁸

¹⁰⁸ This is not an abstract issue. Costs have a significant impact on investor welfare. By way of illustration, the rule of thumb is that additional costs of ½% mean that an investor has to save around 10% more to produce the same unit of income in retirement. Another way of looking at this is to say that ½% worth of unnecessary costs reduce final fund values by 10%, 1% by 20%.

The economic and social audit framework

Losses due to value extraction/ high charges in the asset management sector alone (which provides services to retail investors and pension funds) are much greater than the total costs associated with historic misselling scandals.

An unpublished report quoted in the FT estimated that globally the asset management sector was destroying value equivalent to 2.1% of global GDP¹⁰⁹ per annum due to high costs, underperformance, and poor allocation of resources. If this figure is adjusted for the UK share of the asset management industry, this would suggest that the value destruction for UK clients is equivalent to £25 bn per annum.

The losses incurred by Local Government Pension Schemes alone as a result of poor advice is estimated to be more than £2bn a year (or £17 bn in net present value over 10 years) in the form of high charges and underperformance.¹¹⁰

Given the reliance pension fund trustees place on investment consultants, it is important that these influential intermediaries add value. Unfortunately, good analysis on the performance of UK investment consultants is not available. However, analysis of investment consultants in the US suggest that far from adding value, these intermediaries may be destroying value. US equity funds recommended by investment consultants actually underperformed other funds by 1.1% per annum over the period 1999-2011.¹¹¹

Recent analysis highlights the consistent medium-long term underperformance of equity funds. Whether funds are invested in UK shares (large and small), Europe, US or emerging markets the story is similar – in each case more than 70% of funds underperformed the relevant benchmark over the ten year period.

¹⁰⁹ Source FT: <http://www.ft.com/cms/s/0/3adcb3e6-5c9c-11e0-ab7c-00144feab49a.html#axzz392JYYJnk>

¹¹⁰ The Hidden Cost of Poor Advice: A Review of Investment Decision-Making and Governance in Local Government Pension Schemes ("LGPS"), Clerus, 2014

¹¹¹ As measured on an equal weighted basis. Source: Picking Winners? Investment Consultants' Recommendations of Fund Managers, Journal of Finance, Tim Jenkinson, Howard Jones, Jose Vicente Martinez, September 2014

Table 13: medium-long term performance of £ dominated funds, 10 years to end 2015

Fund sector	% of funds underperforming benchmark
UK Equity	72%
UK Large/ Medium Cap	71%
UK Small Cap	81%
Europe Equity	73%
Europe ex UK Equity	73%
US Equity	94%
Global Equity	89%
Emerging Markets Equity	85%

Source: S&P Dow Jones Indices, SPIVA® Europe Scorecard, p4

Costs due to high portfolio turnover can add up to 0.9% per annum to quoted annual management charges¹¹² of 1-1.5% per annum. The investment fund – not the fund manager - bears these costs so there is little alignment of interests between fund managers and clients. Given that real returns are projected to be 3-4% over next decade this is huge chunk (almost one-quarter) of investors’ potential return.

Retail funds under management have averaged around £400 bn over the past ten years.¹¹³ Reducing annual management charges by just 0.5% (through reducing portfolio turnover and remuneration) would have saved retail investors £2 bn a year.¹¹⁴ Remember, the majority of active managers underperform their benchmarks so these high charges do not add value – this is value extraction in its truest sense. There is an inverse relationship between cost and value in the asset management industry.

Charges are even higher on alternative investment funds such as hedge funds (typical charges can be 2% per annum with a 20% performance fee) even though these alternative funds consistently underperform less expensive, more traditional funds.¹¹⁵¹¹⁶ But for some reason these funds keep attracting large sums of money from clients.¹¹⁷

¹¹² <http://www.ft.com/cms/s/2/11cd09d6-5c80-11e0-ab7c-00144feab49a.html#axzz2mbFyVzA4>, <http://monevator.com/turnover-trackers/>

¹¹³ Asset management in the UK 2014-15, The Investment Association Annual Survey, p9

¹¹⁴ 0.5% of £400 bn is £2 bn

¹¹⁵ <http://www.reuters.com/article/2013/12/23/us-hedge-funds-idUSBRE9BM00620131223>

¹¹⁶ <http://www.people.hbs.edu/gyu/HigherRiskLowerReturns.pdf>

¹¹⁷ <http://www.ft.com/cms/s/0/8c9204ca-67d9-11e3-a905-00144feabdc0.html#axzz38lwHsCPu>

The economic and social audit framework

Financial Inclusion Centre analysis of an OECD study suggests that UK pension schemes on average produced a net real return of -0.7% per annum over 10 years to 2012 compared to a median of 2.4% per annum – an underperformance of more than 3% per annum. According to the OECD's data, UK pension schemes could not even keep pace with inflation over 10 years and underperformed the median in nine of the 10 years covered.¹¹⁸

The UK also spent around £360bn over the past 10 years on pensions tax relief - around 2% of our GDP per annum.¹¹⁹ Pensions tax relief provides an important boost to workers' pensions. But, it is important it is used to greatest effect. Inefficiencies and high costs in the asset management industry (which manages pension scheme assets) undermine the benefits of pensions tax relief.

More generally there have been recurring concerns about the standards of corporate governance in the UK. There have been nine reviews into corporate governance in the UK since 1992. The TUC itself has been in the forefront of work on corporate governance reform and making a strong case for worker representation on boards.¹²⁰

In wholesale markets, the FCA has raised concerns about lack of transparency and competition. The FCA's analysis suggests that competition is not working effectively in this sector. In particular, it highlighted limited transparency on both price and quality which may make it difficult for clients to assess value for money and bundling and cross-selling of services may make it difficult for new entrants to compete and may contribute to low levels of transparency.¹²¹

A recent study from the FCA lays bare the inefficiencies in the asset management sector including the value extracted from investors' funds by high charging fund managers. The FCA estimated that an investor in a typical low cost passive fund would earn £9,455 (24.8%) more on a £20,000 investment than an investor in a typical active fund over 20 years. This could rise to £14,439 (44.4%) once transaction costs have been taken into account.¹²² If scaled up to account for the number of investors using active fund management, this is value destruction on a huge scale.

The FCA also found that the asset management industry is making very large profits. The regulator looked at the operating margins of 44 different industries over the ten years to Q2 2016. It found that the asset management industry had average operating

¹¹⁸ Performance of UK and OECD Pension Funds, Financial Inclusion Centre, December 2014

¹¹⁹ <http://www.cps.org.uk/publications/reports/costly-and-ineffective-why-pension-tax-reliefs-should-be-reformed/>

¹²⁰ See for example Beyond Shareholder Value, TUC, NPI, SOAS <https://www.tuc.org.uk/sites/default/files/BSV.pdf> and All aboard: making worker representation on company boards a reality, TUC https://www.tuc.org.uk/sites/default/files/All_Aboard_2016_0.pdf

¹²¹ <https://www.fca.org.uk/static/documents/feedback-statements/fs15-02.pdf>, p11

¹²² See FCA, Asset Management Market Study, Interim Report, MS15/2.2, November 2016, para 1.5, p9, this assumes the two typical funds, active and passive, achieved the same gross return (ie. Before fees and costs)

margins of over 30% over the period. This was the second highest of the 44 industries analysed. Only the real estate sector turned in a higher average operating margin.¹²³ Such high level of profits coupled with sustained underperformance suggests a serious level of market failure.

This market failure has not dented growth in the asset management sector. Total net revenue (after payment of commissions) was just over £10 bn in 2007, rising to £17 bn in 2015.¹²⁴ The number of people employed in the sector rose from 30,000 to 77,000 over the same period.¹²⁵

Costs of Private Finance Projects¹²⁶

Private finance contracts have been controversial. Rather than fund critical public sector projects and infrastructure through government borrowing, successive governments have turned to the private sector. This had the political advantage of keeping the funding costs off the state balance sheet.

But, compared to government funding, PFI contracts have been costly. According to the Whole of Government Accounts (WGA), the average cost for all government borrowing is between 3-4%, whereas the estimated financing costs for all private financing projects is between 7-8%.¹²⁷ The impact of these higher financing costs are significant. The capital investment value of current private finance deals is £58 bn. But, the total charges for these deals will amount to £310 bn in cash terms over the period of the deals. £78 bn has already been paid, leaving future cash commitments of around £232 bn, an average payment of over £10 bn a year over the next 20 years.¹²⁸

Financial intermediation/ misallocation of resources

It is not easy to measure the costs of misallocation of resources or capital flowing into markets at the top of the market resulting in asset price bubbles. There have been

¹²³ It's worth noting that real estate and asset management scored very badly in the Consumer Markets Scoreboard referred to above – real estate was the worst performing, with asset management third from bottom. Yet these two sectors have been the most profitable over the past ten years on the FCA's analysis.

¹²⁴ Asset Management in the UK 2015-16, Investment Association, Chart 77, p78

¹²⁵ Ibid, Chart 78, p78

¹²⁶ PFIs are agreements in which the private sector funds the construction of buildings and infrastructure, such as roads and IT systems, which might have normally been expected to have been funded by the public sector which are then leased back to the public sector in very long term contracts

¹²⁷ National Audit Office (NAO), the choice of finance for capital investment, para 8, p11. It should be pointed out that some argue that even with higher explicit financing costs, private finance can represent good value if benefits are created for example through risk transfer. However, even this is disputed as even if there is the illusion that the private sector bears the funding risks, when it comes to critical infrastructure, the state will always effectively underwrite the project

¹²⁸ National Audit Office (NAO), The choice of finance for capital investment, para 2.9, p23

a number of asset bubbles over the years.¹²⁹ As an example, the dotcom bubble and subsequent crash saw the market value of dotcom shares fall by \$5trn between 2000 and 2002.¹³⁰ UK investors would have borne a significant share of these losses.

The shock of the 2007-08 financial crisis had a devastating impact on the real economies of major OECD economies. The UK, with its reliance on the financial sector, was particularly badly affected. Financial market shocks don't just come out of a clear blue sky to knock growth off course.

Analysis by the Bank for International Settlements (BIS) shows that financial booms can damage economies by distorting the demand and supply sides.¹³¹ Booms inflate demand and also undermine productivity in economies through the misallocation of labour resources to less productive sectors. The damage occurs during and after the boom period. Specific data for the UK isn't available but the BIS analysed the impact of booms on 22 advanced economies over the period 1980-2010. It found that the drag on productivity during boom periods was around 0.4% per annum.¹³² But the impact post boom was even greater. BIS analysed the impact over a five year post crisis period and found that the drag on productivity was over 0.8% per annum.

Arguably one of the greatest misallocation of resources affecting households happened in the mortgage market. But, this misallocation of resources is also likely to be affecting investment in the real economy (in addition to the short-termism we describe below). The creation of a huge pool of credit saw a boom in mortgage lending. The ratio of total household debt to disposable income rose from under 100% in the late 1990s to 160% by 2008. The customer funding gap amongst major UK banks rose from £30bn to £700bn from 2000-2008. There was no corresponding increase in the levels of home ownership. The main effect was to create a housing bubble (average house prices rose from £60k to £180k over the period¹³³) and cause a huge intergenerational transfer of wealth from younger generations to older generations.

The effects of this will be felt for some time. A review by the FCA found that there were 2.6 m interest only mortgages outstanding. The FCA estimated that 48% may not have sufficient assets to pay off the mortgage.¹³⁴

¹²⁹ <https://www.imf.org/external/pubs/ft/wp/2013/wp1345.pdf>

¹³⁰ Gaither, Chris; Chmielewski, Dawn C. (July 16, 2006). "Fears of Dot-Com Crash, Version 2.0". Los Angeles Times.

¹³¹ See Persistent unusually low interest rates. Why? What consequences? Presentation by Claudio Borio Head of the Monetary and Economic Department, BIS, 85th Annual General Meeting, Graph 2

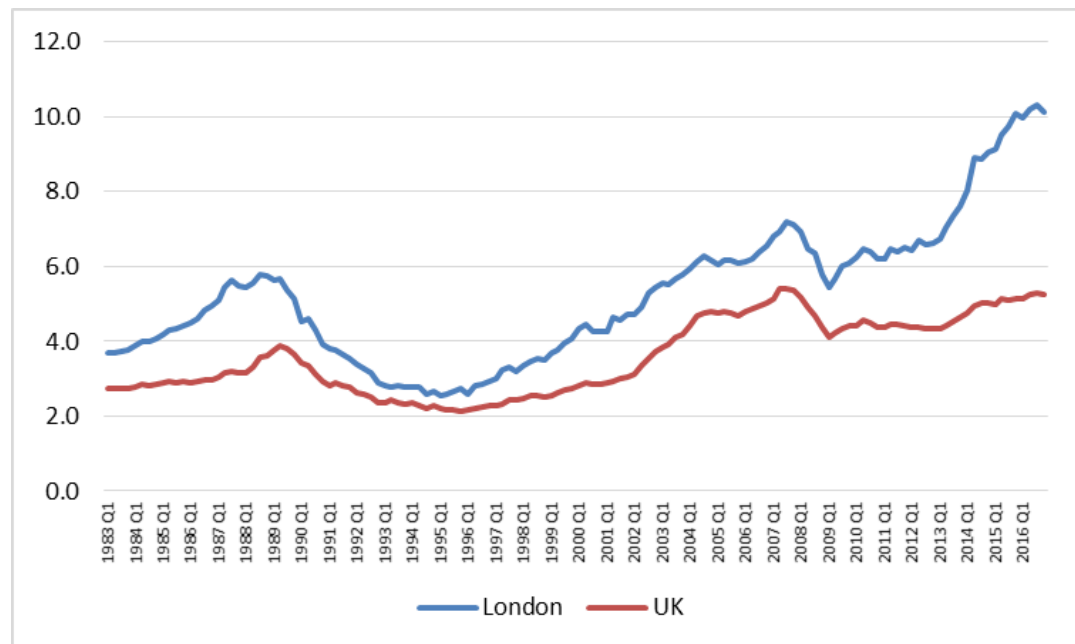
¹³² There is no single time period for the boom period as these would have lasted for different lengths of time

¹³³ http://www.fs-cp.org.uk/publications/pdf/fsa-dp09_03.pdf

¹³⁴ <https://www.fca.org.uk/news/press-releases/fca-publishes-findings-review-interest-only-mortgages-and-reaches-agreement>

As we can see from the chart below, house price earnings ratios across the UK are close to their pre-crisis levels. In the certain parts of the country are actually higher now that they were in the pre-financial crisis period, particularly in the London area.

Chart 2: first time buyer house price earnings ratio – update



Source: Nationwide First Time Buyer, House price earnings ratio¹³⁵

The allocation of financial resources to the property market in the pre-crisis period, resulted in total household debt / income ratios reaching record levels. This fell in the aftermath of the crisis as lending declined rapidly and some borrowers began to deleverage. But, levels of debt are starting to rise again although they are no longer expected to reach pre-crisis levels.

There would also seem to be a link between the behaviours in different parts of the financial system which can cause resources to be misallocated at the macro-financial level. The litany of misselling scandals has left a legacy of mistrust in the financial system. This has undermined consumers' willingness to save for the future through pensions. Less pension savings means fewer resources are channelled into the real economy. Moreover, this lack of confidence has increased the perceived attractiveness of property as an investment – 'bricks and mortar' are perceived as more real and less risky than equity investment - fuelling property prices through the growth in buys-to-let. As explained elsewhere, high levels of credit intermediation – particularly when through property – exerts a drag on productivity and economic growth.

¹³⁵ <http://www.nationwide.co.uk/about/house-price-index/download-data#xtab:affordability-benchmarks>

The flight to quality and the search for yield

One of the most important resource allocation issues relates to the ‘flight to quality’ and the ‘search for yield’ in financial markets which may be creating asset bubbles and causing poorly understood risky investment behaviours.

In the aftermath of the 2007-08 financial crisis, policymakers launched unheralded interventions to stabilise and safeguard the financial system against another crisis, prevent global economies going into full scale depression, and attempt to stimulate economic growth. The Bank of England embarked on huge programmes of quantitative easing (QE), and reduced benchmark interest rates to historically low levels. The UK base rate at 0.25% is the lowest level since records began.

One of the main effects of these interventions has been to depress the yields on benchmark assets such as cash deposits and government bonds. 10 year UK government bond (Gilt) rates were 5.5% in 2007 on the eve of the financial crisis. Yields reached an all-time low of 0.52% in August 2016 and are now hovering around 1% (as at June 2017).¹³⁶

Two major trends pulling in opposite directions are evident – a flight to safe, quality assets which further depressed yields on safe assets and the ‘search for yield’ phenomenon amongst institutional investors such as pension funds¹³⁷ and retail investors seeking to compensate for low returns on safe assets.

There are concerns that asset price bubbles have developed in the bond and property markets¹³⁸ - although for different reasons. In the government bond markets, price rises have been driven by this flight to quality as investors seek safe havens and over the longer term by institutional investors such as pension funds and insurance companies needing to buy bonds for technical regulatory reasons to match long term liabilities. Distortions in the financial markets are such that the value of global government and corporate bonds with a **negative** yield reached \$13.4 trillion – nearly 15% of the total market value.¹³⁹

Whereas, with property, asset price increases have been driven partly by retail investors seeking higher returns than is available in safer assets such as cash and bonds. The growth in the buy-to-let market is part of the ‘search for yield’ evidence amongst retail investors. Low rates of return on ‘safe’ assets also makes it more expensive for consumers to save enough for retirement (the lower the yield on

¹³⁶ See Low for Long? Causes and Consequences of Persistently Low Interest Rates, Geneva Reports on the World Economy 17, Fig 1.2, p5 and <https://tradingeconomics.com/uk/government-bond-yield>

¹³⁷ For example, see the OECD Annual Survey of Large Pension Funds and Public Pension Reserve Funds, Report on pension funds’ long-term investments, December 2015 which describes the Global Search for Yield, p14 and has identified a clear trend towards alternative investments

¹³⁸ <https://www.ft.com/content/739a3700-2eeb-11e5-8873-775ba7c2ea3d>

¹³⁹ As at August 2016, <http://www.zerohedge.com/news/2016-08-15/%E2%80%9C%E2%80%99s-surreal-negative-yielding-debt-rises-record-134-trillion>

annuities, the more consumers have to save to produce the same unit of retirement income), which seems to be exacerbating the growth in buy-to-let as an investment.

The combination of policy interventions and investor behaviour (risk aversion by some and search for yield by others), may also be affecting one of the primary functions of financial markets – the allocation of long term capital to the most economically productive uses.

The fact that we have been living in a low rate, low return world, in theory, should have created opportunities for alternative, socially useful investment opportunities such as green investment and infrastructure investments. But, although we have seen some very small signs of a move towards alternative investments globally the UK seems to be lagging well behind.

For example, the large universities superannuation scheme (USS) pension scheme in the UK has just 0.4% of assets invested in green investments. This is much lower than similar schemes in our economic rival such as France, Sweden, Spain, Netherlands, Denmark, Norway, and New Zealand¹⁴⁰. Similarly, USS has 0% (zero) invested in social impact investments¹⁴¹ and 0.4% invested in infrastructure investments¹⁴² again lower than similar pension funds in other countries.

There has been a significant shift in behaviours amongst large institutional investors with a move away from ‘real economy’ assets such as equities to bonds. For example, in 2001, large UK pension schemes had 46% of assets invested in UK domestic equities – this had fallen to just 16% by 2015. Conversely, holdings in domestic bonds had risen from 17% to 31% over the same period¹⁴³.

But the low interest rate/ return environment has not just affected historic behaviours, it is affecting future behaviours. Large institutional investors are planning to decrease further their holdings in real assets such as equities but significantly increase their holdings in bonds and property¹⁴⁴. Where institutional investors are trying to match liabilities and generate above inflation returns this is being done through alternatives such as hedge funds, structured investment products, and hedging strategies using SWAPs and derivatives, not what we might call economically productive or socially useful investments. There does not appear to be much interest in alternatives such as green investments or social investments.

Despite the efforts of policymakers, prospects for economic growth are not promising so if rates start to rise again increases may be small and incremental. The

¹⁴⁰ OECD Annual Survey of Large Pension Funds and Public Pension Reserve Funds, Report on pension funds’ long-term investments, December 2015, Table 3. Detailed green investments of select LPFs and PPRFs in 2014, p29

¹⁴¹ Ibid. Table 4, p30

¹⁴² Ibid. Table 9, p46

¹⁴³ UBS, The Right Ingredients, Pension Fund Indicators, 2016, Figure 2.5 Asset allocation – key pension markets

¹⁴⁴ Mercer, European Asset Allocation Survey, 2015, Chart 8: Percentage of plans expecting to change investment strategy

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expectation is that rates will be stay low by historical standards for some time to come.

The combination of low economic growth and the maintenance of the ultra-low interest rate policy will affect the expected returns for the main investment asset classes – equities, bonds, and cash. Investors face a new economic and financial reality of low growth and low returns, and the expectation is that they will continue the search for yield.

It is difficult to overstate just how unusual conditions are in financial markets, and it will be a long time before market conditions are ‘normalised’. New risks have emerged in place of the pre-crisis risks. The weak state of the economy makes it difficult to unwind crisis-response interventions (the uncertainty around Brexit exacerbates matters).

This period of low growth and returns will define economic and financial decision-making for some time to come. It is important that we understand the implications for, and consequences of, investor behaviour on financial market resilience, how markets allocate resources to productive economic activities, and the impact on investor expectations and market confidence.

Impact of the ‘shareholder value’ model and short termism on the real economy

The average length of time shares are held in UK stock market fell from almost 8 years in the 1960s to just 7.5 months on the eve of the financial crisis in 2007. The latest estimates suggest that this has stayed at around 6 months. Two thirds of turnover on the UK stock market is accounted for by hedge funds and high frequency traders – who are not known for their long term investment horizons.¹⁴⁵

The behaviour of market investors is of more than just academic interest. There are concerns that the pressure to generate short term returns affects the ability of real economy firms to plan for the future. In the UK market, share buybacks by listed companies have consistently exceeded the issuance of shares over the past decade.¹⁴⁶ The real world impact of this is that the equity market no longer appears to have been a source of net new financing to the UK corporate sector.

Total payouts (in the form of share buybacks and dividends) rose significantly in the period in the run up to the financial crisis. These fell sharply but have since recovered and actually passed their pre-crisis peak in 2014 (these fell again but the post-crisis trend is upwards).¹⁴⁷

Short termism has material costs for firms and the wider economy. Firms that are under pressure to satisfy institutional shareholders through share buybacks or high

¹⁴⁵ <http://www.publications.parliament.uk/pa/cm201314/cmselect/cmbis/603/603.pdf> para 3

¹⁴⁶ Who owns a company? Speech given by Andrew G Haldane, Chief Economist, Bank of England University of Edinburgh Corporate Finance Conference 22 May 2015, Chart 3

¹⁴⁷ Ibid, Chart 4

dividends will have less money for investment. This is supported by recent analysis which compared investment levels in private and public companies with identical characteristics. The analysis suggests that investment, relative to profits or turnover, is consistently and significantly higher among private than public companies.¹⁴⁸

There would seem to be a connection between short termism in financial markets and the dominance of 'shareholder value' as the driving force of investor behaviour. As the TUC highlighted in its work on corporate governance, *'a key criticism of shareholder value is that it disrupts and diminishes the very key to economic prosperity itself, namely innovation'*. The TUC concluded that the pursuit of shareholder value leads to lower levels of investment.¹⁴⁹

As well contributing to asset and income inequality (see next Section), the salaries available in the financial sector (facilitated by high, often illusory, profits and unproductive risk taking activities) may be directly harming the interests of real economy firms by luring talent away. Research suggests that individuals saw an increase of 37% in wages, on average, when they move between the non-finance and finance sectors.¹⁵⁰ It appears that research-intensive firms suffer most when the financial sector booms given the ability of financial institutions to pay higher salaries to attract the best qualified staff.¹⁵¹

C) Negative externalities, wider economic and social costs

As well as creating positive benefits, financial markets should also not create negative externalities. The financial crisis shows us that the negative effects of financial market activities are not necessarily contained within the financial system. The type of negative externalities we looked at include:

- Direct financial crisis costs;
- Indirect costs on the real economy;
- Impact on inequality;
- Regional economic imbalances; and
- Environmental costs.

¹⁴⁸ Ibid, Chart 6

¹⁴⁹ Beyond Shareholder Value, TUC, NPI, SOAS, p8, <https://www.tuc.org.uk/sites/default/files/BSV.pdf>

¹⁵⁰ University of Sheffield, Economics Department, Sheffield Economic Research Papers, Finance Sector Wage Growth and the role of Human Capital, Joanne Lindley Steven McIntosh ISSN 1749-8368, SERPS no. 2014002 January 2014

¹⁵¹ Why does financial sector growth crowd out real economic growth? Stephen G Cecchetti and Enisse Kharroubi* September 2013 <https://evbdn.eventbrite.com/s3-s3/eventlogos/67785745/cecchetti.pdf>

The costs of the financial crisis

The financial crisis created both direct costs and indirect costs, and has had longer term impacts on the wider economy and society.

In terms of direct costs, the public authorities provided two types of support: provision of guarantees and other non-cash support¹⁵² and provision of cash.¹⁵³ According to the National Audit Office, the 'peak' amount of support provided to the banks was £1.16 trn – just over £1 trn in the form of guarantee commitments and £133 bn in the form of cash outlays.

The total current level of support provided to banks has fallen significantly from its peak level as guarantees have matured or removed, and loans have started to be repaid. The NAO estimates that as at end March 2015, the support outstanding is now valued at £115 bn - £22 bn in guarantee commitments and £93 bn in cash outlays.

On top of the explicit support costs, banks were benefiting from hidden state subsidy of tens of £bns each year.¹⁵⁴

Effect on the real economy

In addition to direct financial costs, the collateral damage inflicted to the wider economy has been huge – both in terms of immediate and long term impacts. The UK economy shrank by 7.2% over 2008-09. But, perhaps more worryingly, there appear to have been serious long term effects on the UK's economic productivity. Both financial sector productivity and wider economic productivity has been affected.

Looking at the overall economy, it is estimated that if productivity had been maintained at pre-crisis levels, it would be around 20% higher than it is now. This, of course, has a very real impact on the real economy and society. UK economic output is significantly lower than it would have been if the financial crisis had not happened. It is difficult to estimate precisely the losses created. But estimates for value of long term lost output range from £1.8trn-£7.4trn.¹⁵⁵ Whatever the precise figure, the reduction in economic output affects living standards and reduces the amount of resources available for spending on public services.

¹⁵² including Credit Guarantee Scheme, Special Liquidity Scheme and Asset Protection Scheme, as well as other guarantees and indemnities provided to UK banks.

¹⁵³ in the form of loans to the Financial Services Compensation Scheme and insolvent banks to support deposits, and the purchase of share capital in Royal Bank of Scotland and Lloyds Banking Group.

¹⁵⁴ On Tackling the Credit Cycle and Too Big To Fail, Andy Haldane, 2011

¹⁵⁵ http://www.economist.com/blogs/freeexchange/2010/03/crisis_costs

Data from the ONS shows a striking deterioration in the relative productivity¹⁵⁶ of the UK financial sector compared to other major economies before and after the economic downturn. Over the pre-downturn period 2005-09, UK output per hour in financial services was above that of all four comparator countries - US, Italy, France and Germany. However, more recently, over the period 2010-14, the picture was almost completely reversed. UK financial sector output per hour was estimated to be lower than the US, Italy and France with the lead over Germany narrowing sharply.¹⁵⁷

What explains the reversal in productivity in financial services? One point to consider is that the claims about the contribution the financial sector makes to the economy may have been significantly overstated or flattered by the sheer amount of activity on the financial markets much of which was unproductive, speculative or was not properly priced (so the costs were externalised to society). Much of the growth may have just represented greater risk taking rather than any real improvements in productivity.¹⁵⁸ As has been said many times, the rewards were privatised, the risks socialised.

Furthermore, not only does the impressive performance of the financial sector itself appear to be have been partly illusory, it appears that overreliance on a financial services can affect growth in the real economy.

Analysis by the IMF of the impact of the financial crisis on productivity shows that countries which experienced a banking crisis saw a bigger hit to productivity compared to those countries that escaped a banking crisis. The median loss in potential output in 2014 for all countries covered in the analysis was 2.3%. 19 countries are considered to have experienced a banking crisis over the period 2007-11.¹⁵⁹ For those countries, the median loss in potential output in 2014 is around 5.5%. This compares to a median loss of only 2% for those countries which did not experience a banking crisis. The UK saw a loss of potential output of 6.9% in 2014. So, not only did the UK perform badly compared to all the countries in the study, it performed badly compared to the group that had experienced a banking crisis.

Impact on economic structures

There have been concerns raised that the growth in the City has crowded out real economy activities such as manufacturing. It is very difficult to prove cause and effect in this relationship. Of course, if financial services grow and take a greater share of economic output then by definition, the share of GDP accounted for by

¹⁵⁶ As measured by Gross Value Added (GVA) per hour worked

¹⁵⁷ ONS, Statistical Bulletin, International comparisons of productivity - final estimates, 2014, Table A5, published February 2016

¹⁵⁸ What is the contribution of the financial sector: Miracle of Mirage, Andrew Haldane, Simon Brennan and Vasileios Madouros

¹⁵⁹ Austria, Belgium, Denmark, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Luxembourg, Netherlands, Portugal, Slovenia, Spain, Sweden, Switzerland, the United Kingdom and the United States, based on analysis by Laeven, L. and F. Valencia (2012), "Systemic Banking Crises Database: An Update", IMF Working Paper, WP/12/163, June

manufacturing would fall. But this does not necessarily mean that financial sector activities are constraining manufacturing. However, it should be pointed out that financialisation has been accompanied by greater capital flows into the UK which has had the effect of keeping sterling exchange rate higher than it would have been. This would have damaged manufacturing sector competitiveness.

Effect on inequality

Research suggests that when financial services play a bigger role in economies and financial market liberalisation occurs beyond a certain point this can result in greater economic inequality – both in terms of asset and income inequality. Moreover, policy responses to financial crises – created by an over-reliance on the financial sector – in turn can also have a negative effect on economic inequality.

A recent working paper published by IMF staff¹⁶⁰ found that capital account liberalization reforms are associated with a statistically significant and persistent increase in inequality. Liberalisation typically increased the Gini coefficient¹⁶¹ by 0.8% in the short term (one year after a liberalisation happened) and 1.4% in the medium term (five years after).

This is supported by other research. The OECD concluded that financial expansion contributes to greater income inequality through two mechanisms. Higher income households can benefit more from the greater availability of credit which can be used for investment opportunities and because the financial sector pays high wages which are well above those available to workers with similar profiles in other sectors.¹⁶²

OECD simulations found that an increase in credit intermediation is typically associated with slower income growth for 90% of the population but higher growth for the top 10% - indeed the lower the income decile the worse the impact on income growth. A rise in stock market capitalisation is associated with higher income growth for most of the population but not for the bottom 30%.¹⁶³

Similarly, some would argue that the way our money supply is created (our money is created by banks as debt) is guaranteed to result in a transfer of income and wealth to better off households. Analysts estimate that 10% of the population are net receivers of interest while 90% are net payers of bank interest.¹⁶⁴

¹⁶⁰ IMF Working Paper, Capital Account Liberalization and Inequality, Davide Furceri and Prakash Loungani, November 2015, WP/15/243

¹⁶¹ The Gini coefficient is a measure of inequality

¹⁶² See http://www.oecd-ilibrary.org/economics/finance-and-inclusive-growth_5js06pbhf28s-en

¹⁶³ Boris Cournède, Oliver Denk, Peter Hoeller Finance and Inclusive Growth, OECD Economic Policy Paper, June 2015, No. 14, Figure 11: Simulated effects of credit and stock market expansion vary across the income distribution

¹⁶⁴ PositiveMoney, <http://positivemoney.org/2013/10/our-money-system-guarantees-that-inequality-will-get-worse-here-is-the-evidence/>

There is also the impact of asset price bubbles on household financial resilience – asset bubbles are associated with falls in the household savings ratio.

Developed economies have seen major changes in the distribution of the share of income between wages and profits over the past four decades – albeit less so in the UK. Over the same period, greater ‘financialisation’ of economies has taken place. Financialisation of economies involves financial deregulation, processes such as securitisation, greater orientation towards shareholder value rather than public value, and increasing household debt.¹⁶⁵

In recent analysis of 14 OECD countries, researchers found that the wage share fell from 73 per cent of national income in 1990 to 65 per cent in 2011.¹⁶⁶ The fall in wage share is also closely related to rising income inequality. This analysis attributed this to several main factors:

- Financial globalisation increases the opportunities for firms in one country to relocate to another – physical location of a firm is increasingly no longer tied to the location of sources of capital. This threat of moving allows firms to increase their bargaining power with workers.
- Greater pressure from investors and lenders for higher returns or loan payments can impact on prices for goods and services which in turn has an impact on real wages.
- Linked to this, greater demands from investors for short term gains can increase the pressure on owners and managers to cut costs by holding down wages or increasing the use of outsourcing – this exacerbates income insecurity and inequality.
- More generally, there is a link between increased overindebtedness and income inequality.¹⁶⁷

In the UK, financial markets were liberalised in 1986 through the major reforms known as the ‘Big Bang’. Researchers have estimated that the Big Bang led to the share of pre-tax incomes going to the top earners increased by 20% in the subsequent five years.¹⁶⁸ The main reason seems to be that financial liberalisation led to a significant growth in the earnings of employees in the financial sector. Financial sector employees do tend to earn more than employees in other sectors. UK research

¹⁶⁵ For a definition of financialisation and an analysis of its effects see Consequences of Financialization, Liam Gennari, August 2016

¹⁶⁶ <http://blogs.lse.ac.uk/politicsandpolicy/financialisation-makes-income-distribution-more-unequal/>

¹⁶⁷ Note that greater access to credit which can be used for investment opportunities can exacerbate inequality – while greater access to credit for consumption purposes and to make ends meet can also exacerbate income inequality if it leads to overindebtedness

¹⁶⁸ Does Financial Deregulation Boost Top Incomes? Evidence from the Big Bang, Julia Tanndal, Brown University Daniel Waldenström Uppsala University, CEPR, IZA and IFN , Discussion Paper No. 9684, January 2016

found that controlling for gender, age, and region of residence, finance sector workers are found to earn 48% more on average than non-finance sector workers.¹⁶⁹ Financial sector employees make up 67% of top decile earners in the UK. Financial sector workers, especially the highest earners, are obtaining ‘rents’ as a result of the wage premia¹⁷⁰ they earn over other workers in the economy.¹⁷¹ The high remuneration in the sector makes a significant contribution to income inequality in the UK.¹⁷²

The size of bonuses alone paid to City staff can have a distorting effect on wage inequality. Academic research has found that 60% of the increase in extreme wage inequality from 1998 to 2008 can be attributed to financial sector bonuses.¹⁷³

Despite some of the obvious market failures, there is no real sign that earnings in the financial sector saw the level of adjustment that might be expected given the extent of the market failure caused by financial institutions. In Q1 of 2000, average weekly earnings (inc bonuses) in the whole economy were £300 per week; for the financial and insurance sector this was £711 per week – the ratio of earnings in the financial sector to whole economy was 2.31 times. By Q1 2008, average whole economy earnings had risen to £440 per week, compared to financial and insurance sector earnings of £1,562 – a peak ratio of 3.55 times. The crash had an impact on the financial and insurance sector. Average whole economy earnings fell to £428 in Q1 2009, while financial and insurance sector earnings fell to £1,128 – with the ratio down to 2.63. But that was still higher than the ratio for 2000. The trend has been rising again. Average whole economy earnings were £500 per week in 2017 but financial and insurance sector earnings were £1,632 – this means the ratio is now back up to 3.26, not far off the 2008 peak.¹⁷⁴

Bonuses as a share of total earnings in the financial and insurance sector (as a whole) have fallen from a peak of 34% in 2007 to 23%. But this is still significantly higher than the rest of the economy where bonuses make up just 4.5% of total earnings. The

¹⁶⁹ University of Sheffield, Economics Department, Sheffield Economic Research Papers, Finance Sector Wage Growth and the role of Human Capital, Joanne Lindley Steven McIntosh ISSN 1749-8368, SERPS no. 2014002 January 2014

¹⁷⁰ The financial sector wage premium is the percentage by which gross annual earnings of weighted full-time full-year equivalent employees in finance exceed those in other sectors

¹⁷¹ Financial sector pay and labour income inequality: evidence from Europe, OECD working papers no. 1225 By Oliver Denk

¹⁷² As measured by the Gini co-efficient, see Table 2. Financial sector employment, wage premia and labour income inequality, Financial sector pay and labour income inequality: evidence from Europe economics department, OECD working papers no. 1225 By Oliver Denk

¹⁷³ Bell, B and J. Van Reenen (2010) Bankers Pay and Extreme Wage Inequality in the UK, Centre for Economic Performance Special Paper No CEPSP21

¹⁷⁴ FIC calculations of ONS average weekly earnings data

<https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsearn01> and

<https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/datasets/averageweeklyearningsbyindustryearn03> ratios are calculated by working out the average of three month data for Q1 of relevant years

average bonus per employee in the financial and insurance sector was £13,400 in 2016 up from £13,100 in the previous year. In contrast, the average bonus in the whole economy for 2016 was just £1,600.¹⁷⁵ The finance sector accounts for 32% of total bonuses paid in the economy.¹⁷⁶

In any other area of the economy, market failure on this scale would have resulted in revenues and remuneration being massively reduced with large scale market exits and closures resulting. But as the example of the asset management sector shows, this does not seem to be the case in financial services. The participants who make financial markets (asset managers, investment bankers, analysts, credit ratings agencies etc.) are in some ways self-appointed arbiters of economic efficiency whose decisions and activities result in huge amounts of capital being directed towards and withdrawn from different sectors of the economy, firms opened and closed, jobs created and lost. However, the financial sector seems much more immune to the same disciplines.

The fact that workers in the financial sector earn more than other workers is not a surprise. But it is perhaps surprising that the differential grew and appears not to have been constrained by the financial crisis. Some of this finance sector premium can be explained by qualifications and cognitive skills. But the characteristics of the employees or the jobs do not fully explain the premium. Researchers suggest that this may be partly explained by rent seeking of the finance sector's profits.¹⁷⁷

More recently, it looks as if quantitative easing (QE) and the ultra-low interest rate environment introduced as a response to the financial crisis, have contributed to increases in asset prices - for example, through supporting higher equity valuations and returns, and growth in property prices – which in turn has contributed to wealth inequality.^{178 179}

¹⁷⁵ Data for financial year end 2016, see

<https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours/bulletins/averageweeklyearningsbonuspaymentsingreatbritain/financialyearending2016>

¹⁷⁶ Total bonuses in financial year end 2016 were £44.3 bn. Finance and insurance services made up £14 bn of this total.

¹⁷⁷ University of Sheffield, Economics Department, Sheffield Economic Research Papers, Finance Sector Wage Growth and the role of Human Capital, Joanne Lindley Steven McIntosh ISSN 1749-8368, SERPS no. 2014002 January 2014

¹⁷⁸ Government bond rates have dramatically reduced post financial crisis boosting the value of bond holdings. Low rates have also underpinned equity valuations. Better off households tend to hold proportionately more assets such as equities and bonds so have benefited more than lower income households.

¹⁷⁹ see "Wealth inequality and monetary policy", Dietrich Domanski, Michela Scatigna and Anna Zabai, Bank for International Settlements, BIS Quarterly Review, March 2016

Effects on the wider economy

The UK is very dependent on its financial sector. At one level, this can be positive – as the data on gross value added and contribution to trade balances show. But, there are also very clear negative aspects to this.

Increased financialisation does seem to be associated with asset price bubbles and more pronounced economic swings. During the 1950s and 1960s, falls in real GDP, compared to the previous peaks, were relatively common. But these were also short-lived and by comparison modest in scale. Since 1970, however, there have been four recessions. Each of these recessions have been deeper and more prolonged than those in the preceding 25 years. As measured from peak-to-trough, the most recent recession was the deepest since the 1930s and could be the longest on record, in terms of the time it takes before real GDP returns to its previous peak.¹⁸⁰ There is a strong case for saying that if the financial sector played a smaller role in the UK economy prior to the 2007-08 crisis, the subsequent recession would have been smaller and the recovery stronger.

Recent analysis by the OECD looked at the relationship between i) the value added of finance, ii) credit by banks and similar institutions to the non-financial private sector (intermediated credit) and iii) stock market capitalisation and GDP in different countries.¹⁸¹ It found that financial value added and credit are negatively linked with GDP growth. But stock market capitalisation was positively linked. The relationships between these factors for the UK was found to be strong.¹⁸² The analysis also found that overinvestment in housing represents one source of the negative link between intermediated credit and GDP growth.¹⁸³ This supports other analysis that increased financialisation can lead to misallocation of economic resources and reduce productivity growth by encouraging investment in projects such as in construction which generate low returns but provide easily pledgeable collateral.¹⁸⁴

An increase in household credit has had a larger negative impact than business credit. Similarly, lending through banks has a bigger negative impact than non-bank lending

¹⁸⁰ Don't bank on it: the financialisation of the UK economy, IPPR, December 2012, p33 and fig 4.2 http://www.ippr.org/files/images/media/files/publication/2012/12/dont-bank-on-it-financialisation_Dec2012_10058.pdf?noredirect=1

¹⁸¹ Cournède, B. and O. Denk (2015), "Finance and economic growth in OECD and G20 countries", OECD Economics Department Working Papers, No. 1223, OECD Publishing, Paris. <http://dx.doi.org/10.1787/5js04v8z0m38-en>

¹⁸² Cournède, B. and O. Denk (2015), "Finance and economic growth in OECD and G20 countries", OECD Economics Department Working Papers, No. 1223, OECD Publishing, Paris. <http://dx.doi.org/10.1787/5js04v8z0m38-en>, Table 9, p26

¹⁸³ Cournède, B. and O. Denk (2015), "Finance and economic growth in OECD and G20 countries", OECD Economics Department Working Papers, No. 1223, OECD Publishing, Paris. <http://dx.doi.org/10.1787/5js04v8z0m38-en>, para 27, p22

¹⁸⁴ Cecchetti, S. G. and E. Kharroubi (2015), "Why Does Financial Sector Growth Crowd Out Real Economic Growth?", BIS Working Papers, No. 490

such as bonds. But further expanding equity financing was found to have a positive impact on economic growth.¹⁸⁵

The OECD analyses established five factors that link growth in credit to slower economic growth: i) excessive financial deregulation; ii) a more pronounced increase in credit issuance by banks than other intermediaries; iii) too-big-to-fail guarantees by the public authorities for large financial institutions; iv) a lower quality of credit; and v) a disproportionate rise of household compared with business credit. But, expansions in stock market funding in general boost growth.

Regional economic imbalances

The level of regional economic disparity within the UK is much greater than other countries in Europe.¹⁸⁶ EU wide analysis also reinforces just how wide the gap is in the UK between London and the regions.¹⁸⁷ This gap has widened since the 1980s.

Interestingly, analysis has shown that regional disparities actually widened after the financial crisis with London (even with its reliance on the financial sector) pulling away from the rest of the country. London's output per head grew to over 170% of the national average in 2012¹⁸⁸ – it remains at 170%.¹⁸⁹

The variation in regional experiences is striking. The financial crisis of 2007/08 hit the UK economy and regional economies hard. Since then real GDP (adjusted for inflation) per head at UK level has now passed its pre-crisis peak (in 2007). But, in only two regions – London and the South East – was real GDP per head in 2015 estimated to be above pre-crisis peaks. In other regions, real GDP per head was still below pre-crisis peaks. In some cases, the lack of recovery is striking. In Northern Ireland, real GDP per head was 11% below its peak, while in Yorkshire and Humberside it was 6% below peak.¹⁹⁰

A similar pattern can be found looking at the data on real household disposable income. Disposable incomes in most regions have not experienced recovery. Moreover, the biggest gains in income can be found in those regions where disposable income was already higher than the national average,¹⁹¹ while the biggest

¹⁸⁵ <http://oecdinsights.org/wp-content/uploads/2016/03/Figure-1.pdf>

¹⁸⁶ The Dysfunctional UK Economy, A macroeconomic assessment of whether the UK economy is strong and secure, Margaret Cuthbert, A paper for the Jimmy Reid Foundation, June 2013, see Chart 2

¹⁸⁷ [http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Regional_disparities_in_gross_domestic_product_\(GDP\)_per_inhabitant,_in_purchasing_power_standard_\(PPS\),_by_NUTS_level_2_region,_2013_\(%C2%B9\)_\(%25_of_the_EU-28_average,_EU-28_%3D_100\)_RYB15.png](http://ec.europa.eu/eurostat/statistics-explained/index.php/File:Regional_disparities_in_gross_domestic_product_(GDP)_per_inhabitant,_in_purchasing_power_standard_(PPS),_by_NUTS_level_2_region,_2013_(%C2%B9)_(%25_of_the_EU-28_average,_EU-28_%3D_100)_RYB15.png)

¹⁸⁸ Financial Times, London widen gaps with regions, January 2012,

<http://www.ft.com/cms/s/0/b91d7d4c-2cb9-11e1-8cca-00144feabdc0.html#axzz440wVflxl>

¹⁸⁹ ONS, Regional Gross Value Added (income approach), UK: 1997 to 2015

¹⁹⁰ Source: Whose recovery? Speech given by Andrew G Haldane, Chief Economist, Bank of England, Port Talbot, Wales, 30 June 2016

¹⁹¹ Note that the regional disparities is not uniform – that is, even within London region, once incomes are adjusted for housing costs, certain groups have not fared well

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losses were found in those regions with the lowest incomes. In other words, regional distribution of incomes appears to have widened since the crisis.

Of course, it is not possible to attribute the disparity in regional economic performance entirely to the City but it seems sensible to assume that it must have a significant impact. The data on finance's contribution to the economy of various UK regions supports this. Finance and insurance contributes 19% of gross value added (GVA) to the economy of London compared to an average UK figure of just over 8%. London accounted for more than 50% of the total GVA of the finance and insurance sector. The share of the UK economy accounted for by the finance and insurance sector grew from 6.6% to 8% in 2014 (albeit down from 9% in 2007).¹⁹²

Analysis also shows that south's dominance in financial services has grown significantly from the 1970s to 2010.¹⁹³

Diversity in the City

The UK financial sector is not a very gender diverse place – certainly at senior level. 13% of members of ExcOs (executive committees) of major UK financial institutions are women.¹⁹⁴ 82% of FCA approved persons are male – only 18% are female.¹⁹⁵ The gender related pay gap in business, finance and related professional services is 20%.¹⁹⁶

¹⁹² House of Commons Library, Financial Services: contribution to the UK economy Standard Note: SN/EP/06193, February 2015, Tables 1 and 2

¹⁹³ Gardiner B, Martin R and Tyler P (2012) 'Spatially unbalanced growth in the British economy', unpublished paper, quoted in Don't bank on it: the financialisation of the UK economy, IPPR, December 2012, fig 4.5

¹⁹⁴ Oliver Wyman, Women in financial services, Exhibit 2, http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2014/dec/OW-Women-in-Financial-Services-04_12_14_FINAL-v3.pdf

¹⁹⁵ FCA Data Bulletin January 2015 edition - underlying data pack. Approved persons by gender

¹⁹⁶ Diversity and inclusion in banking, BBA, November 2015, Box 2

Environmental costs

There is widespread acceptance that climate change presents a threat to investment returns, financial resilience, and longer term prosperity.¹⁹⁷ However, work by ShareAction¹⁹⁸ and others show how the investment industry is failing to exercise due diligence and have underestimated the importance of financial risks associated by climate change. A recent survey found that only 7% of asset owners have calculated the carbon footprint of their portfolio and only 1.4% have an explicit target to reduce it.¹⁹⁹ Not only does this suggest that these asset managers may be in breach of their fiduciary duty to beneficiaries, it is disappointing that these influential investors are not exercising proper stewardship over the impact of their decisions on the environment.

Tax avoidance

Estimates suggest that the total loss to the exchequer from tax avoidance is around £19 bn per annum (data for 2013/14)²⁰⁰. Tax avoidance is tax that is lost when a person claims to arrange their affairs to minimise tax within the law in the UK, or in other countries²⁰¹. Tax avoidance is of course legal but there is no question that financial planning solutions designed by professional services firms in the financial sector reduce the UK's tax base – which obviously has an impact on the resources available for public services and so on.

Other externality costs

There may be other 'externality' costs on top of those described above such as the impact of market speculation on food and other commodity prices, and destabilising effect of global capital flows (as opposed to real trade flows) on vulnerable economies. We have not included these externality costs as they happen at an international level and it is difficult to isolate the UK component.

¹⁹⁷ See for example speech by Mark Carney, Governor of the Bank of England, FSB proposes creation of disclosure task force on climate-related risks, FSB, November 2015. <http://www.financialstabilityboard.org/2015/11/fsb-proposes-creation-of-disclosure-taskforce-on-climate-related-risks-2/>

¹⁹⁸ Note, the main author of this report is a board member of ShareAction

¹⁹⁹ Asset Owners' Disclosure Project (AODP), Recognising the Value at Risk from Climate Change, Economist Intelligence Unit, July 2015

²⁰⁰ The tax gap – tax evasion in 2014 and what can be done about it, A report by Richard Murphy FCA of Tax Research UK for the Public and Commercial Services Union <http://www.taxresearch.org.uk/Documents/PCSTaxGap2014.pdf>

²⁰¹ This is different to tax evasion – tax lost when a person or company deliberately and unlawfully fails to declare income that they know is taxable or claims expenses that are not allowed.

But it is worth noting that financial positions in food commodity markets have exploded. The figure was \$12 bn in 2000, rising to \$80 bn in 2007 on the eve of the crisis. This fell to \$60 bn in 2008 but rose again to \$120 bn in 2011.²⁰²

D) Financial stability and economic resilience

- Even though we have seen a major programme of regulatory reforms on financial stability and prudential regulation, concerns remain that:
 - the UK economy's continued reliance on the financial sector and its role as a global financial sector leaves it very vulnerable;
 - risks are being displaced to less well-regulated parts of the financial system;
 - the risks of contagion from the financial system have not been properly contained;
 - the financial system is nowhere near diverse enough to ensure financial resilience and continuity in the event of a new crisis; and
 - existing risks may be exacerbated and new risks created by Brexit (if for example, the UK deregulates to attract new business to offset lost EU financial exports) – but the impact on the City and the ability to manage those risks will very much depend on which form of Brexit the UK goes for and how policymakers respond.
-

Compared to previous financial market crises (such as Black Monday in September 1987 or the bursting of the Dotcom bubble in 2000/01), the crisis of 2007/08 was unusual in:

- the nearly catastrophic impact it had on our core *financial* system (the first phase financial crisis);
- the way it spread out from the financial system to damage the wider economy in the form of a major recession and prolonged slowdown (the second phase *economic* crisis); and
- the damage done to the real economy which subsequently caused serious harm to household incomes and public finances (the third phase *social* crisis).

Post financial crisis, a number of major regulatory reforms were introduced to:

- Improve financial stability and reduce the risk of another systemic crisis recurring (known as macro-prudential regulation); and
- Improve the soundness of our systemically important financial institutions (known as micro prudential regulation). Most of the emphasis in the UK has been on the

²⁰² Future Agricultures, Food price volatility and financial speculation Stephen Spratt Institute of Development Studies, April 2013, Chart 2

first and second priorities – financial stability and micro prudential reforms (although there has been sustained efforts to improve conduct of business in ‘retail’ financial services).

We will not know whether this regulation is effective unless it is tested by a new financial crisis. Of course, we must hope we don’t see a recurrence of the 2008 crisis but many commentators are worried about the global financial markets and that even with the programme of reforms, the City still represents a major threat to wider economic resilience.

Specifically, the main areas of concern are:

- The reforms to improve the soundness of the UK’s systemically important retail banks (specifically, the increase in the capital buffers they are required to hold, leverage measures and the ring-fencing measures designed to insulate the retail arms of universal banks from financial market shocks and ensure they can be resolved efficiently in the event of failure).²⁰³.
- At a macro-economic level, the UK economy is still too imbalanced and over-reliant on financial services and bank and household debt.
- Externality costs are still not factored into business models and financial activities – in other words, there is little disincentive to stop possibly dangerous financial activities.
- Risks may have been displaced from the mainstream financial sector to the ‘shadow-banking’ system (driven partly by tougher regulation of the mainstream banking sector) making it more difficult to identify and mitigate risks.
- Policy decisions to counter the effects of the financial crisis (QE at low interest rates) have distorted markets.
- The ‘flight to quality’ by investors means that equity and bond markets appear to be overvalued and there are fears that asset price bubbles have been created.
- The low interest rate/financial return environment is causing investors to seek higher returns (the so-called ‘search for yield’) without necessarily understanding the risks involved.
- Policymakers and regulators are finding it difficult to keep up with financial and technological innovation – our key financial networks and infrastructures are obvious targets for cyber-attacks.
- The risks of contagion from the financial system to the wider economy have not been reduced.

²⁰³ Concerns have been raised by Sir John Vickers who chaired the Independent Commission on Banking which developed the new proposals on ring fencing that the way the Commission’s recommendations are being implemented by the Government and Bank of England are not strong enough, see: <http://www.voxeu.org/article/how-much-equity-capital-should-uk-banks-have>

The economic and social audit framework

- The financial system is nowhere near diverse enough to ensure financial resilience and maintain core financial services in the event of a new crisis.

The UK's role at the centre of the global financial system (and as one of the leading financial centres) makes it unusually exposed to risks in the financial markets. The current size of the City in relation to the real economy is already a cause for concern.

If current trends outlined in the first section continue the City will become even bigger. The UK's market based financial system is currently six times the size of GDP. This is forecast to rise to 15 times GDP by 2050.²⁰⁴

Even after adjusting for London's role as a global financial sector, the UK had the second highest ratio of total debt-to-GDP (469%) of any major economy after Japan and saw the largest increase in total debt relative to GDP from 2000 through 2008. The internal financial liabilities of the UK financial sector rose from around 10% of GDP in 2000 to 550% in 2008. This fell to 400% in 2012 but this exposure to risk still represents a serious threat to the UK's financial stability and resilience.²⁰⁵

As a result of failures in the traditional banking sector and established forms of financial intermediation (and some would argue as an unintended consequence of macro and micro prudential regulation), there has been a growth in non-bank finance such as 'other financial intermediaries' (OFIs) and 'shadow banking'.²⁰⁶ This is not necessarily a bad thing as new forms of financial intermediation may actually be more efficient and flexible than mainstream bank funding thereby promoting diversity and more efficient competition. This greater diversity in the financial system could also promote greater economic and financial resilience.

Compared to its major economic rivals, the UK has a large non-bank finance sector – measured as a proportion of GDP. The shadow banking sector in the UK is close to 150% of GDP, while the OFI sector is valued at around 340% of GDP,²⁰⁷ this is much bigger than its G7 rivals – Canada, France, Germany, Japan, Italy, and USA.

But, the growth in the non-bank finance sector raises concerns. It creates a range of risks. It is a form of financial intermediation so it is vulnerable to 'run risks' similar to those present in banking. It can also be vulnerable to leverage and pro-cyclicality risks – if market sentiment turns, deleveraging can reinforce market falls. The ability to leverage can also contribute to asset price bubbles. On the one hand, it can be argued that shadow banking promotes diversity but the corollary of that is greater complexity and connectivity. Certain non-bank finance activities are in turn financed by short term wholesale market borrowing which creates connectivity risks in the

²⁰⁴ Mark Carney, Governor of the Bank of England:

<http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech865.pdf>

²⁰⁵ How serious a threat is the UK's financialised economy?, Jim Cuthbert for Jimmy Reid Foundation, July 2014

²⁰⁶ These include money market funds, finance companies, structured finance vehicles, hedge funds, other funds, broker-dealers, real-estate investment trusts and funds.

²⁰⁷ See Financial Stability Board (FSB), Global Shadow Banking Monitoring Report 2015, Exhibit 6, p12

wider financial system. But, non-bank financing is not subject to bank-like prudential regulation. On the conduct side, non-bank financing is very complex and opaque and can involve multiple intermediaries which can result in conflicts of interest and agency problems.

Increased market activity and greater use of derivatives, far from resulting in greater liquidity and more resilient markets appear to have resulted in less safe, more fragile markets.²⁰⁸ Concerns have been raised about the impact of short selling and use of credit default swaps (CDS) – so much so that legislation has been brought in to allow regulators to temporarily ban or limit these activities.²⁰⁹

The growth of specific innovations such as high frequency trading or algorithmic trading has led to concerns about uncontrollable market disruption such as ‘flash crashes’.²¹⁰ The interconnectivity of modern financial markets means that these activities represent a risk to financial stability and resilience.

Nor does it look as if these innovations led to more efficient financial markets from the perspective of households and the real economy. The net result appears to be more market risk and vulnerability with no discernible efficiency gains for the clients or real economy but with a need for more intensive, expensive regulatory monitoring, supervision and enforcement.

The failure to regulate growth in debt has meant that policymakers now have to maintain interest rates at rates well below normal levels. This in turn has now created its own new set of problems with asset price bubbles and risky financial behaviours as investors search for yield.

Is the economy more resilient to financial system shocks?

Although major financial stability risks remain, at least progress has been made on macro and micro prudential regulation. But, it is not at all clear that progress has been made on the third challenge. Unless we develop viable, sustainable alternative financial systems and promote financial system diversity and plurality, greater economic resilience will not be possible. Moreover, the absence of alternatives leaves society vulnerable to the ‘too-big-to-fail’ syndrome. Big banks and financial institutions will always be in a strong position to repel attempts at reform given our reliance on these institutions to organise the financial system.

From the point of view of encouraging diversity and plurality, it is encouraging that we are seeing the development of new forms of financial institution such as P2P lenders and web based payment system providers. But, *as it stands*, these alternative

²⁰⁸ Tapping the Brakes: Are Less Active Markets Safer and Better for the Economy?, Joseph Stiglitz, Presented at the Federal Reserve Bank of Atlanta 2014 Financial Markets Conference

²⁰⁹ http://europa.eu/rapid/press-release_MEMO-12-523_en.htm?locale=en

²¹⁰ For example, in May 2010, nearly \$1trn was wiped off the US stockmarkets due a flash crash see: <http://www.motherjones.com/politics/2013/02/high-frequency-trading-danger-risk-wall-street?page=1>

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providers provide a tiny fraction of savings and lending to households and real economy firms.

Similarly, non-profit organisations such as credit unions and responsible finance providers have yet to make any real inroads into the market shares of the established financial institutions. We do not believe that these new institutions will make a significant contribution to economic resilience.

Moreover, there may be around 2,500 payment services providers. But the critical payment systems infrastructure is still dominated by a handful of providers.

The New Economics Foundation (NEF) has developed a Financial System Resilience Index for the G7 countries (United States, Canada, Japan, Germany, France, the UK, and Italy). This index is based on seven factors: diversity of financial system,²¹¹ interconnectedness, financial system size, asset composition, liability composition, transparency and complexity, and leverage.

As the table below shows, the UK scores significantly lower than its major economic rivals in terms of overall financial resilience.

Table 14: Financial resilience of the UK financial system

G7 Country	NEF Index score
Germany	73
Japan	71
France	66
Italy	63
Canada	62
USA	56
UK	27

Source: NEF Financial Systems Resilience Index

NEF reconstructed this index going back to 2000. On this basis, the UK's financial resilience index was declining sharply in the run up to the financial crisis. It has recovered slightly but still remains well below our G7 rivals.

The conclusion must be that, although we have made progress in terms of financial stability and prudential regulation, more needs to be done to improve the diversity and plurality of the UK financial system to increase its resilience against future financial shocks. And, now of course, now we have to consider the potential effects of Brexit on the UK financial system. Industry lobbyists are likely to start pushing

²¹¹ This in turn is based on market concentration, funding model diversity, and geographical diversity

for a 'deregulation dividend'. If they are successful, this could create new systemic and prudential risks – see below.

Section six

The Potential impact of Brexit

As of yet, it is difficult to say with any real degree of precision how Brexit will affect the UK financial sector, how it is regulated, and therefore what the consequences will be for the real economy and households.

First of all, it depends on which form of Brexit the UK adopts (or more accurately which deal with the UK the EU agrees to). Secondly, the impact will not be felt equally across all of the main financial sectors because of the different applications of EU Regulations and Directives, interactions with the World Trade Organisation (WTO) rules, and the way the critical ‘passporting’ rights apply to the different financial sectors. Thirdly, the impact will also depend on how the UK government responds to various post-Brexit scenarios – that is, how much EU-derived prudential, conduct of business and consumer protection regulation is retained.

But, we can identify some of the potential issues and risks that may arise particularly if the UK goes down the hard-Brexit route.

Possible Brexit scenarios

There are a number of possible ways the UK could leave the EU ranging from ‘soft-Brexit’ where the UK joins the European Economic Area (EEA) to ‘hard-Brexit’ which involves a more complete separation and the UK engaging with the EU under a free trade agreement (FTA) or under World Trade Organisation (WTO) rules.

Joining the European Economic Area (EEA): if the UK joins the European Economic Area (EEA), it is likely nothing much would change (in financial services and general consumer protection) areas. But, the UK would not have a say, apart from being consulted, in the formulation of the EU legislation that has to be adopted by EEA members. This is the model adopted by Norway, Iceland, and Liechtenstein.

Outside the EEA: there are three possible models outside the EEA. The UK could join the European Free Trade Association (EFTA), stay in the Customs Union, or negotiate a Free Trade Agreement (FTA). These allow for free movement in goods but not in services. New arrangements would need to be put in place to keep UK and EU law closely aligned in certain key sectors (for example, financial services). EU law already in theory allows for the recognition of non-EU ‘equivalent’ financial services regimes, which would permit firms to sell products and services into the EU without further licensing (but only at present in professional markets). The UK would still need to unpick, amend or replace EU legislation to create a coherent new regulatory framework even if it works broadly in the same way as the pre-Brexit regime, because of the ‘equivalence’ requirements. EU regulations having direct effect would lapse unless replaced by similar UK legislation. The EU would

probably insist that consumer protection rules remain broadly equivalent in the relevant sectors kept aligned.

WTO/ 'hard-Brexit': if an agreement is not reached, the UK would default to World Trade Organisation rules. This would be the most disruptive and could involve root and branch rewriting of UK law which would take years to complete. This would also be the highest risk option from a consumer protection and conduct of business perspective. This option creates the risk of widespread deregulation as being 'competitive' on the world stage may become a race to the bottom in terms of attracting footloose global businesses.

The UK may try to negotiate some form of hybrid or bespoke model to protect its economically significant industries such as financial services but this will very much depend on the willingness of the EU and its Member States to negotiate and agree a deal. This should not be dismissed entirely for financial services. A strong argument is being made that the UK financial sector isn't just of economic significance to the UK economy but is critical to the whole EU economy.²¹² But, this does not appear to be a likely outcome as EU policymakers will be very wary of allowing the UK to cherry pick the best parts of belonging to the EU for fear of setting a precedent for other Member States.

Ultimately, the form of Brexit adopted will be driven primarily by political decisions on the other 'freedoms' particularly the free movement of people freedom. That is, the more the UK insists on a hard line on free movement of people, the 'harder' the Brexit deal will be with all that entails for financial services.

Impact on existing financial regulation

As mentioned, the impact on UK financial consumers will depend on which form of Brexit the UK adopts. Defaulting to the WTO Rules system creates the greatest risks to financial consumers in the UK in terms of potential reductions in consumer protection standards and conduct of business regulations. The key EU legal instruments we need to consider are Directives and Regulations.

Regulations: these have direct effect in Member States, without any need to change domestic law (though Member States may have done so in order to remove resulting ambiguities and inconsistencies). EU Regulations which have not been implemented via UK legislation will 'fall away' and will no longer have force in the UK unless the UK Parliament introduces legislation to replace the relevant EU Regulation. Of course, this would have to be planned for and implemented before Brexit happens.

Directives: these tell Member States what legal results must be achieved, but Member States have flexibility as to how to bring about those results by means of domestic law. In the UK, this has been done by primary legislation (mainly Acts of

²¹² As the Governor of the Bank of England put it: 'the UK is the investment banker for Europe', see FT, November 30, 2016, <https://www.ft.com/content/608bc2d5-2134-3b55-a11b-585dec9a4d0d>

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Parliament) or secondary legislation (such as statutory instruments). Regulatory measures implemented through primary legislation will remain in place post-Brexit – unless repealed or amended by the UK. However, it would appear that those Directives implemented through secondary legislation would no longer have effect in the UK unless alternative legislation was introduced.²¹³

Non-EU financial legislation and regulations: as well as EU-derived legislation, it is important not to forget non-EU legislation and regulation. Although this category is not directly affected, there is an obvious risk that financial services lobbies will take advantage of the opportunity provided by Brexit to argue for reductions in the overall ‘regulatory burden’ including domestic legislation and regulations.

It is important to note that it is not just consumer protection and conduct of business regulations which are under threat. Critical, financial stability and prudential regulations could also be affected.

Timing and transitional issues

Article 50 (the Article in the Treaty of the European Union (TEU) which sets out the process for leaving the EU) was triggered in March 2017. If the timetable is followed, two years after this, the UK will no longer be inside the EU. There is no guarantee that negotiations will have been concluded by then.

If the UK is to get an extension to the time limit, this requires unanimous agreement from the other Member States. But there is no guarantee that this will happen – indeed the UK Government might not want an extension given the political pressure in the UK to exit as soon as possible. The likelihood is then that the UK will have left the EU by March 2019.

This does not allow for much time to negotiate a deal along the lines outlined above. If a deal is not completed, the default position would be for the UK to operate according to the WTO Rules. The WTO rules are designed mainly to deal with trade in products not services such as financial services. Any agreement under WTO Rules would also take a significant amount of time to negotiate. This arrangement would be the most damaging for the UK financial services industry as it would see access to EU markets much reduced.

There is a risk that the UK financial services industry would be faced with a ‘cliff-edge’ post Brexit. Therefore, it is likely that the UK Government will try to negotiate some form of transitional arrangement with the EU. We cannot say at this stage what form this transitional arrangement might take. There is speculation that this might involve the UK paying an ‘access fee’ to ensure the financial services industry can still trade with the EU. But, again this will all depend on the willingness of the EU and the Member States to negotiate and agree a deal.

²¹³ See Eversheds, Making sense of Brexit, What will it mean to leave the EU?, p7 <http://www.eversheds.com/global/en/where/europe/uk/services/competition-eu-and-regulatory/brexit-brochure-zmag.page>

Impact on the financial sector and financial markets

Of course, we don't yet know the extent of the impact of Brexit on the UK financial sector and markets. However, some attempts have been made to model the potential impacts.

For example, work undertaken for the CityUK by PWC²¹⁴ estimated that, compared to the counterfactual, UK financial services GVA would decline by between 5.7% - 9.5% by 2020²¹⁵ – this is equal to £7-£12 bn in 2015 prices. This is then expected to moderate over time, falling to 1.8%-4% of GVA by 2030.

Moreover, given the importance of UK financial services to the UK economy, this would have an impact on wider GDP. PWC estimate that UK GDP, compared to the counterfactual, would decline by between 3.1%-5% by 2020 moderating to 1.2%-3.5% decline by 2030.

Certainly, key parts of the financial services industry are very concerned about the impact of losing passporting rights. A very recent survey conducted on behalf the FTfm (The FT's fund management supplement) found that 70% of asset managers fear the loss of the EU passport and will not be able to sell funds freely across the EU.²¹⁶

Moreover, the risks to financial stability of a disorderly Brexit have been highlighted recently by the Bank of England.²¹⁷ But, a disorderly Brexit is also likely to affect EU markets given the role the City of London plays in providing corporate finance to the EU economy. As the Governor the Bank of England put it: 'the UK is effectively the investment banker to Europe'.²¹⁸

Impact on financial consumers

But what are the implications for UK retail financial consumers?

The impact on consumer protection, conduct of business, market integrity, prudential regulation, and financial stability regulation will all depend on politics and which deal is struck between the UK Government and the EU. If the UK Government decides that curtailing the Freedom of Movement of Persons is the priority then from what EU policymakers have so far said, this points towards a WTO Rules scenario (that is 'hard-Brexit'). However, we just cannot say at this stage. If the UK financial sector does end up with the WTO scenario, there must be a risk that the industry lobby would push for deregulation arguing that this is necessary to cut costs and promote competitiveness in a more difficult trading scenario.

²¹⁴ PWC, Leaving the EU: Implications for the UK financial services sector, April 2016

²¹⁵ depending on which form of Brexit adopted ranging from a Free Trade Agreement to WTO Rules scenario

²¹⁶ 70% of asset managers fear Brexit fund passport loss, FT fm, December 5, 2016

²¹⁷ <http://www.bankofengland.co.uk/publications/Pages/fsr/2016/nov.aspx>

²¹⁸ <http://uk.reuters.com/article/uk-britain-boe-idUKKBN13P0HV>

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Therefore, from the perspective of UK financial consumers, there are two main drivers to worry about post-Brexit – the economic impacts on the industry and the deregulation agenda – which will create risks for UK financial consumers.

Economic impacts on the UK financial services industry²¹⁹ : Brexit may have a significant impact on the revenues and profitability of geographically diversified UK financial services firms (see above). But even before the prospect of Brexit raised its head, economic and financial conditions were very challenging for key parts of the mainstream financial sector which face the prospect of demand side pressures,²²⁰ low economic growth, weak returns on investment,²²¹ growing pressure from more agile challengers, more realistic regulation, while having to deal with legacy²²² costs. If Brexit results in UK firms losing significant EU business, this may cause UK financial services firms to try to offset losses by increasing revenue and profitability from UK consumers and, with the possibility of deregulation on the horizon, in ways that harm UK consumers (see below).

Deregulation agenda: the industry is likely to use these economic pressures as an excuse to push for deregulation post-Brexit, arguing that regulation is a burden. A number of well-resourced and connected industry lobbies²²³ are already working hard to influence the Brexit agenda. Brexit provides the reason for government to review UK legislation derived from EU Regulations and Directives to determine which is to be retained, revised, retained, unwound or unpicked. But, it is worth noting that, while the large part of UK financial legislation and regulation is derived from EU legislation, there is still a significant body of non-EU financial regulations which may be at risk from the argument that regulation is a burden.

²¹⁹ Note that Brexit could have wider impacts on UK retail investors and pension savers if economic growth and, therefore, investment returns are reduced. But we have not covered the impact on returns in this briefing

²²⁰ UK households are still facing a squeeze on real earnings. Purchasing financial services are not always a priority.

²²¹ For example, the FT reported that the return on equity for the seven largest UK banks is currently just 2.5% - much lower than the 10-12% that has been the case historically, see British Banks' capital is only half the problem, FT, 1st December 2016, p16. While operating margins are reasonable, banks' conduct of business redress costs have had a major impact on reducing profitability. According to the FCA, insurance companies have one of the lowest operating margins of 44 sectors studied. But not all financial sectors are suffering- the asset management industry has the second highest operating margin after real estate – see FCA, Asset Management Interim Report, Fig 6.21, p118.

²²² For example, IT systems, uncrystallised redress costs

²²³ The City of London Corporation (through The CityUK and International Regulatory Strategy Group), The Financial Services Task Force, The Financial Services Negotiating Forum plus various individual trade associations such as the Association of British Insurers, The BBA, Investment Association. This is just a fraction of the industry lobbyists. We count over 50 financial services trade bodies operating in the UK. In addition, it is estimated that of the 700 organisations representing financial services in Brussels (trade associations, public affairs firms and lobbyists, PR firms, lawyers, etc), 140 are from the UK, see http://corporateurope.org/sites/default/files/attachments/financial_lobby_report.pdf

It is worth noting that it is not just deregulation we need to worry about. Brexit may be used as an excuse to stop much needed new regulatory reforms. For example, the asset management trade bodies have been using Brexit to warn the FCA off major reforms of the sector as part of the Asset Management Review.

As mentioned, there are potentially serious near term risks if the UK is unable to arrange a transitional deal and manage an orderly Brexit. But, there are longer term risks - again depending on which form of Brexit the UK adopts. We see two major categories of regulatory risk.

The first relates to financial stability and prudential regulation. Post financial crisis, UK policymakers (along with EU and international counterparts) have introduced a series of major reforms to make the financial system safer and improve the soundness of our major financial institutions. If UK financial services finds itself facing restricted access to EU markets it may increase its efforts to attract more custom from other parts of the world to offset a loss in business. The result may be an increase in the proportion of financial flows through and funds managed in the City of London originating from less well-regulated parts of the global financial system. This could create new systemic risks for the UK financial system. It could also undermine the integrity of the UK's financial markets.

The global nature of financial services means that the development of many of these important measures have been led by international political and regulatory bodies such as the G20, FSB, the Basel Committee, IOSCO, and IASB²²⁴ and implemented through EU legislation.

Post-Brexit, the ability of the UK to significantly reduce financial stability and prudential regulation standards may be limited. International political and regulatory bodies will be keen not to weaken regulation given how important the UK financial sector is to the global financial system.

But, the UK financial services lobby had already been complaining that the EU, when interpreting and implementing global standards, had gone further than international bodies had intended.²²⁵ It is likely that the UK financial services industry will turn its attention to influencing international standards. This is something consumer advocates will need to monitor to ensure that risks to savers, investors, pension scheme members, and insurance policyholders are not increased through a reduction in prudential regulation.

The second risk relates to a possible weakening of conduct of business and consumer protection regulation. Outside of the purview of the EU policymakers (European Parliament, Commission, and Supervisory Authorities), the financial services industry may be emboldened to push for a 'bonfire of red tape' given the current

²²⁴ FSB, Financial Stability Board; Basel Committee, Basel Committee on Banking Supervision; IOSCO, International Organisation of Securities Commissions; IASB - International Association of Insurance Supervisors

²²⁵ A good example, is the Solvency II Directive which governs the prudential regulation of EU insurance companies and is designed to minimise the risk of insurers going bust

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political mood for deregulation in the UK. It seems fairly certain that the industry will push for deregulation arguing that it needs to cut regulatory costs in the face of economic challenges outlined above. But, the real motive will be to try to transfer the risk of future misselling costs to consumers. This suggests that it should be a priority for consumer advocates to ensure that critical financial regulation is hard-wired into the UK's financial regulatory system in advance of Brexit.

Opportunities

Of course, it should be recognised that Brexit may create opportunities to reform the UK financial sector, not just risks.

One argument is that in the future the UK financial services firms will focus less on the EU and more on servicing the needs of domestic markets, with the potential for enhanced competition.

Moreover, consumer confidence and trust in UK financial services remains very low. This may act as a check on the deregulatory agenda. Brexit will surely trigger a wholesale review of UK financial regulation creating the ideal opportunity to fashion a regulatory system which suits more closely the needs of the UK financial consumers.

At a more general level, Brexit may create a once-in-a-generation opportunity, and act as the trigger, for the reforms that many in civil society have been calling for to: make financial markets safer, reduce the impact of financial market crises on the real economy, rebalance the economy away from financial services, address short termism in financial markets, and improve the economic and social utility of the City so that it focuses less on proprietary activities and more on providing services that households and the real economy needs.

But, we must be realistic. It is not clear that civil society has the credible policies that would produce the desired reforms, or that there is the political will for reform on any real scale given the importance of the financial sector to the UK economy. Policymakers will need to be persuaded that the potential benefits of reform outweigh the potential costs – in other words, the Government will be afraid of killing the goose that lays the golden egg.

Moreover, reform of any significance will be the work of years. In the near term, the focus of the Government and regulators will be on averting Brexit related systemic risks and minimising the economic impact of Brexit on the City (indeed the Government may ratchet up efforts to help the City attract more business from other parts of the global economy exacerbating the risks identified in this paper).

Section seven

Conclusions and further questions

As mentioned in the Introduction, it is not possible - and would be misleading to try - to come up with a single figure which claimed that the net worth of the City of London to the UK is £X bn or Y% of GDP. Nevertheless, this analysis reinforces a number of important points:

- An efficient financial sector is critically important to the efficient functioning of the real economy and for meeting households' financial needs.
- The UK's financial sector is huge and complex – indeed the size of the UK's financial markets and the number of transactions carried out on the markets and various payment and clearing systems is staggering.
- The UK's financial sector is much larger as a proportion of GDP than its major economic rivals – the gap has grown over time and is set to grow even further.
- The sector makes a significant contribution to the UK economy including to the UK's trade balance – its contribution has grown significantly over the years.
- Along with the sheer size of the City, the defining feature is its international nature – the UK is one of the leading (on several measures, the leading) global financial centres.
- As well as being a leading centre for the more established financial services such as investment banking, asset management, and insurance, the City is one of the leading centres for the new fintech industries.

But, set against the undeniable contributions, are the huge economic and social costs, and risks created by the City. Indeed, many of the very features of the City which produce value for the UK (the contribution towards GDP, the sheer scale and global nature of the UK's financial markets) create those costs and risks. In addition to risks and costs, there are fundamental questions to be asked about the economic and social utility of the financial sector. The charge sheet against the City is long and serious.

- The sector has faced huge redress costs as a result of poor conduct and misselling to retail customers and real economy firms. These redress costs have had wider effects on the functioning of the banking sector – costs have hit the bottom line, constraining the capital available to support lending to the real economy.
- Confidence and trust in the financial sector has been badly affected. Small firms remain reluctant to borrow from banks. Financial services remain one of the least trusted consumer sectors. This has an effect on consumers' propensity to save for future needs such as a pension so creating longer term public policy problems. The lack of trust and confidence, in turn, adds to the perceived attractiveness of

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property as a pension, contributing to house price bubbles (recently in the form of buy-to-let investment) – which in turn diverts resources away from the real economy.

- Although poor conduct and retail misselling cases have received a much higher profile, the cost of market failure in the form of value extraction and poor performance in the vital pensions and investment industry has been much greater – this is before we take into account the externality costs such as the impact of short-termist thinking by the investment industry on real economy firms, misallocation of resources to unproductive uses, and the impact on inequality.
- The short term investment horizons of powerful institutional investors affects the ability of real economy firms to plan for the future and invest in research and development – which further undermines long term economic sustainability and productivity.
- Real questions remain about the degree to which the financial sector serves the real economy rather than its own interests. The primary purpose of much of the activity in the City seems designed to extract value from already existing assets – or indeed to manufacture synthetic assets from which to extract value. The bulk of investment bank revenue in recent years has been derived from providing services to other parts of the financial system rather than to real economy firms. Over the recent years, the majority of lending (by value) went to other parts of the financial system and property (without increasing the level of home ownership) – a minority went to real economy firms.
- Greater financialisation and misallocation of resources by the financial sector not only diverted resources away from real economy activities but fuelled asset price bubbles which then increases the risk of financial crisis with further consequences for the real economy. Financialisation can amplify boom and bust cycles in the real economy. There is a strong case for saying that if the UK financial sector had been smaller pre crisis, the subsequent crisis would not have been deep and prolonged.
- But it isn't just vulnerability to financial crises we have to worry about. Greater financialisation of the economy is negatively linked with growth in GDP - particularly if it associated with investment in existing assets such as housing rather than new, productive assets.
- The direct and indirect costs of the financial crisis have been huge – we are still paying the costs in terms of direct and implicit subsidies and because of the impact on long term economic output. UK long term economic output is much lower than it would have been without the financial crisis – the UK suffered comparatively badly because of its dependence on financial sector activities. The UK's financial sector itself has seen a reversal of productivity.
- There are other costs to consider. When financial services play a bigger role in economies this can result in wider economic inequality – both asset and income inequality. An increase in credit intermediation is associated with higher income

growth for the top income decile of a population but lower growth for the rest. Asset price bubbles also undermine household financial resilience. The growth in financial sector salaries and bonuses has contributed to wage inequality. Moreover, the level of salaries in the financial sector appear to affect real economy firms by luring the best talent away – especially in research intensive industries.

- Regional economic disparities are large in the UK with major gaps between London and the rest of the UK. While it cannot be attributed entirely to the dominance of the City, the growth in London’s financial sector must have had a major impact.
- The City is not diverse. The top jobs are still dominated by white males.
- Although there has been some progress, the institutional pension, investment and insurance industries still fail to exercise due diligence and underestimate the financial risks associated with climate change.
- The activities of the wider professional services firms associated with the City are estimated to be losing the UK Exchequer £bns a year in lost tax revenue through advice on tax avoidance.
- Post financial crisis, a number of major financial stability and prudential regulatory reforms were introduced to try to make our financial system and systemically important financial institutions safer and to protect the real economy from the consequences of financial crises. We won’t know for sure whether these reforms go far enough unless the financial system is tested by another crisis.
- Concerns remain that: the UK economy’s continued reliance on the financial sector and its role as a global financial sector leaves it very vulnerable; risks are being displaced to less well-regulated parts of the financial system; the low interest rate environment (itself a response to the financial crisis) is causing investors to take undue risks in the ‘search for yield’; new asset price bubbles are being created; the risks of contagion from the financial system have not been properly contained; and that the financial system is nowhere near diverse enough to ensure financial resilience and continuity in the event of a new crisis.
- But, now we have Brexit on the horizon with creates heightened risks for the financial sector and, therefore, the UK economy especially if the UK fails to negotiate a transitional deal to prevent a disorderly exit from the EU.

Next steps and further questions

The major dilemma at the heart of this subject is: is it possible to reform the financial sector in a way that addresses the risks and market failures identified in this paper without losing the benefits the sector brings? To say Brexit complicates matters is an understatement.

Resolving that dilemma would require further work to address a series of important policy questions:

Conclusions and further questions

- We need greater diversity in our financial system to reduce our reliance on ‘too big to fail’ financial institutions and to improve competition and innovation. But, ‘alternative’ providers of financial services represent are still tiny compared to the large, mainstream financial institutions. Without major policy interventions to shape the financial system and create space for growth, it is very difficult to see how smaller institutions will achieve enough ‘organic’ growth to provide a real alternative to the big banks and financial institutions. However, the fact that these institutions are too big to fail, means that policymakers may lack the courage to promote real change for fear of ‘killing the golden goose’. The question here is: is it possible to develop interventions which would change the structure of the UK financial system (particularly to reduce the dominance of the banks in credit and money creation) to promote economic resilience and greater diversity and plurality, and persuade policymakers to implement these policies?
- Generating revenue from overseas clients is per se good for the UK economy – if it is done in a way that doesn’t create risks and costs in the financial system that outweigh those benefits. Is it possible to target policies which would ensure UK domestic clients (households and real economy firms) get a better deal while still allowing the UK financial sector to generate significant revenues from overseas clients? Brexit will clearly have consequences for the way the UK financial sector trades with overseas markets.
- Restoring and maintaining confidence and trust in the financial system is a priority. This won’t happen unless the culture of the City also changes. But, do we know what it takes to restore confidence given the reputation of the financial sector? Culture emerges from the system in which people operate – the structures, incentives, fear and greed etc. Can we be confident that the system has changed sufficiently to give us confidence that the dominant culture is changing?
- Misallocation of resources and short-termism are major issues, creating asset price bubbles and undermining sustainable economic growth. Do we have the detailed, well thought through policies which would encourage more efficient resource allocation and long term thinking?
- While the City makes a major contribution to GDP, too great a dependence on financial services appears to undermine productivity and sustainable economic growth. This suggests that we might be better off if the City was cut down to size. But, if the City was cut down to size, what would take its place? Would real economy activities fill the gap and offset the loss in contribution to GDP? But this raises several related questions? Do we have the economic analytical framework to allow us to assess the impact on the UK economy if dependence on the City was reduced? Do we have the actual policies which would engineer the necessary rebalancing and, critically, would we have the courage and opportunity to implement these policies?
- Despite a number of major regulatory reforms at international, EU and UK level fears remain that the UK economy remains vulnerable to failure in the financial system. Greater financial and economic resilience would be improved if our

financial system was more diverse and the City cut down to size – see above. But system change on this scale would take a long time to deliver. In the meantime, more work is needed to provide reassurance that financial stability and prudential regulation reforms are robust enough. In particular, the key questions are: will the ring fencing proposals protect retail banks which provide loans and banking services to households and the real economy from investment banking activities; and do the more demanding capital requirements go far enough to safeguard retail banks?

- Brexit creates major new risks. It also provides the opportunity and impetus for positive reform of the City. But, does civil society have the capacity and policies to deliver those reforms.
- Even before the extra pressure created by the need to respond to Brexit, there were concerns about the capacity of civil society organisations to influence financial market reforms. Consumer groups have been effective in the past at scrutinising behaviours in retail financial services and holding firms to account (for example, obtaining redress for consumers affected by misselling). But wider civil society has not been that effective in scrutinising and holding to account wholesale and institutional financial markets. The necessary reforms will not happen unless civil society develops robust policies and influence policymakers. The question is: how do we ensure civil society builds the capacity?
- Overall, these questions can be summed up by asking: what should the City of London look like in a post-Brexit world; what role do we want it play in our economy; and do we have the policies, policy structures and political will to make the necessary reforms happen? These are big questions and we look forward to debating these with stakeholders over the coming years.

Annex

Glossary

Function	Definition
Actuaries/ Actuarial services	Professionals who calculate insurance risks.
Algorithmic/ 'black box' / high-frequency trading	Automated trading in financial assets carried out according to pre-programmed instructions; these are executed at speeds well beyond the capacity of humans.
Analysts	Analysts are professionals who research and analyse the financial prospects for markets, companies, and other financial instruments. They provide this research to fund managers and other investors.
Arbitrage trading	Shares and other financial assets may be traded on a number of exchanges at the same time. However, there may be very small differences in the prices on different exchanges. Arbitrage traders seek to exploit those small differences.
Asset backed securities (ABS)	See Securitisation, below.
Asset managers/ fund managers	Fund managers are professional who invest and manage assets (equities, bonds, property etc.) on behalf of investors. They receive a fee for doing so. They are a very important part of the financial system as they gather capital from savers and investors and invest in real economy firms or lend money to governments and companies in the form of bonds.
Bank of England	The UK's central bank. The Prudential Regulation Authority (PRA) and Financial Policy Committee (FPC) sit within the Bank – see below.
Benchmark activities	Benchmarks play a critical role in financial markets nowadays. They are used to determine prices of financial instruments, measure investment performance, and sums of money payable from financial contracts. In the UK, the use of eight major benchmarks relating to interest rates, foreign exchange, derivatives, oil futures, gold etc. are regulated by the FCA. ²²⁶

²²⁶ See <https://www.fca.org.uk/markets/benchmarks> for list of benchmarks regulated by the FCA

<p>Bond markets</p>	<p>A bond is a form of debt. Governments or corporates can raise money by issuing bonds on primary markets which are bought by investors. In return for buying bonds investors receive an interest payment called a 'coupon'. The rate of interest expected by investors is linked to the perceived risk of lending to the bond issuer. The higher the risk, the higher the interest rate expected. Bonds are traded on secondary markets.</p>
<p>Brokers</p>	<p>A broker is a market intermediary who buys and sells financial assets on behalf of investors – for example, a stockbroker or commodities broker - and receives a fee or commission for doing so.</p>
<p>Broker-dealers</p>	<p>Broker-dealers are intermediaries who trade on behalf of clients and also on their own account (in this case they are dealers).</p>
<p>Capital markets</p>	<p>Capital markets are one of the main parts of the financial system where governments, companies and other organisations (e.g. local government) raise capital from investors. This could be in the form of equity (shares), debt (bonds), or various hybrid instruments. There isn't a single capital market rather a plethora of trading systems around the global financial system (almost entirely electronic based these days) hosted by stock exchanges, investment banks, and government departments. Primary markets are where new shares or bonds are issued. Secondary markets are where shares and bonds are traded between buyers and sellers. Another important distinction is between exchange trading which takes place on organised, regulated exchanges with transparent prices and over the counter (OTC)/ off-exchange trading which takes place directly between two parties in a market.</p>
<p>Central Counterparties (CCPs)</p>	<p>CCPs are also known as clearing houses and are a very important part of the infrastructure of financial markets. Whenever a buyer and seller execute a trade there is a risk that one party might default on the trade. CCPs act as counterparties to the trade and ensure that if one party defaults, the other party does not lose out. In the UK, CCPs are authorised by the Bank of England.</p>
<p>Clearing and settlement systems/ houses</p>	<p>Clearing and settlement systems are a critical part of the financial market infrastructure. Whenever a transaction takes place in the financial system, these transactions have to be paid for and ownership transferred from one party to the other – this is known as clearing and settlement and is operated by specialist clearing and settlement houses.</p>

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<p>Closed-end funds/ investment trusts</p>	<p>Closed-end funds are another form of collective investment which allows investors to pool their investments. The oldest and best known closed-end funds are investment trusts. Investment trusts are traded on the stockmarket. The first investment trusts were set up in the late 1800s. However, unlike open-ended funds such as unit trusts, which allow the manager to create new units or shares to meet new demand from investors, closed-end funds have a fixed number of shares. This is an important distinction as it means there can be a divergence between the share price of the investment trust and the underlying assets.</p>
<p>Collateral management</p>	<p>The use of collateral in its basic form has been around for ages. Whenever one party makes a loan, they will often expect the borrower to put up some collateral as security against the risk of the loan not being repaid. But, more recently, the use of collateral has been used in more complex transactions such as derivatives.</p>
<p>Collateralised debt obligations (CDOs)</p>	<p>CDOs are a form of asset backed securities. The defining feature is that the assets within the CDO are packaged into different tranches which are rated according to 'seniority' or safety. Investors will buy different tranches depending on their attitude to risk and return. If some of the loans which form the underlying assets of the CDO default, the most junior tranche suffers losses first. But, to compensate, these junior tranches will receive a higher coupon or interest payment.</p>
<p>Collective investment funds</p>	<p>Allow large numbers of individual investors to pool their money to invest in assets such as equities/ shares, bonds, and property. Collective investment funds allow investors to spread the risk across a number of investments and share the cost of investing. There are a number of different types of collective investment funds including unit trusts, investment trusts, and exchange traded funds.</p>
<p>Credit default swaps (CDS)</p>	<p>Credit default swaps are a form of insurance or hedge against the risk of default on a bond or other form of debt contract. For example, if an investor owns a bond, they can pay a premium to the seller of a CDS who will compensate the investor in the event of the bond defaulting. However, investors can use CDS for speculation as they don't have to have any underlying economic interest in the company whose bonds they are insuring. In effect, they are making a bet on the credit worthiness of firms they might have no interest in.</p>

Credit rating agencies	When governments or companies issue debt, for example in the form of bonds, this is rated according to how likely the entity is to default on interest payments or to go bust. The higher the risk, the higher the return investors will seek. These ratings are called credit ratings and are undertaken by specialist research agencies called credit rating agencies (CRAs). There are a number of CRAs each with their own rating system – for example, AAA, AA-, BBB etc.
Credit reference agencies	Individual borrowers are assessed on their ability to repay loans and given a credit score. These assessments are carried out by credit reference agencies (CRAs).
Custodian/ depositary banks	The role of a custodian or depositary bank is to safeguard clients' assets separate from a financial institution that may manage those assets. It can also be involved in settling transactions, collecting information and keeping records about ownership of assets and securities, and dealing with the administration of securities.
Dark pools	A dark pool is a market which allows financial institutions to trade securities outside of the public exchanges such as the London Stock Exchange or New York Stock Exchange. The growth in electronic trading has facilitated the increased use of dark pools. These markets allow institutional investors to buy and sell large blocks of shares without moving markets. But, there are concerns that these dark pools have reduced transparency in markets.
Debt capital markets	See Capital Markets.
Derivatives	A financial product whose value is derived from the value of another underlying asset – for example, stockmarket indices, commodities, interest rates or currencies. Examples of derivatives include futures, options and swaps and variations on these. Derivatives are used for genuine hedging purposes but also for speculation.
Deposits	Money held with a bank or building society.
Equity markets	Where company shares are traded.
Exchange traded funds (ETFs)	ETFs are like unit trusts in that they hold assets in shares, bonds etc. The ownership of the fund is divided up into shares held by individual shareholders. The main difference is ETFs can be traded on markets throughout the day. They are usually cheaper than unit trusts.

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Financial Conduct Authority (FCA)	The FCA regulates the conduct of business of firms and individuals working in financial services. It protects consumers, promotes competition, and market integrity in financial markets.
Financial infrastructures	Financial infrastructures refer to the critical parts of the financial system and operators which allow markets to function. For example, clearing and settlement systems, payment systems, and so on.
Foreign exchange markets	Where currencies are traded. The foreign exchange markets are huge.
Futures	Financial futures are a form of derivatives (see above). A futures contract is an undertaking to buy or sell a physical commodity (e.g. oil) or financial instrument (e.g. interest rates) at a specified future date and at a specified price. Futures were originally used to hedge risks but are increasingly used to speculate on market movements.
General insurance companies	General insurance is also known as non-life insurance and refers to insurances such as car insurance, home contents insurance, buildings insurance, and travel insurance.
Hedge funds	A hedge fund pools capital from a number of investors (usually sophisticated or institutional investors) to invest in assets. These are distinct from unit trusts/ ETFs in that these often use leverage (that is borrowing) to try to boost the returns produced, or hedging techniques to produce positive returns even when markets are falling. They also charge much higher fees than more conventional funds such as unit trusts/ ETFs.
Information providers	There are a huge range of information providers operating in financial markets from providers of real time equity/ bond share prices, credit rating agencies, and so on.
Initial public offering (IPO)	This is when shares in a company (equity) are first offered to the market or a company is first launched on the market. This is generally done with the help of an investment bank and underwriters to ensure shares are taken up by investors – see below.
Institutional fund/asset managers	Institutional fund managers tend to specialise in providing services to larger investors such as pension funds, local authorities, and large charities.

Investment banks	Investment banks play a critical role in the financial system and markets. They provide corporate finance services to firms listing on stock markets or undergoing mergers and acquisitions, and governments raising money through bonds. They also make markets in financial instruments, and trade with other banks and financial institutions to make profits on their own account and to hedge risks.
Life Insurance companies	Life companies sell life insurance and long term savings products such as savings and investment bonds, personal pensions.
London Market/ Lloyds of London	The 'London Market' insures large or specialist risks such as film stars, footballers, art and so on, and commercial risks. The best known insurer in this market is Lloyds of London. Technically speaking, Lloyds is not an insurance company but is a corporate body governed by its own Act of Parliament (the Lloyd's Act of 1871) and subsequent Acts. Lloyds itself does not insure risks. Instead, large numbers of financial backers (members) come together in syndicates to underwrite risks in return for premiums. One of the unusual features of Lloyds is that some of the members are private individuals – known as 'Names'.
Market making	Market makers quote a price for buying and selling financial instruments – thereby making a market in those instruments.
Money markets	Money markets allow financial institutions to borrow and lend money in the short term – from overnight to one year.
Mortgage backed securities (MBS)	See Securitisation.
Non-bank finance	See Shadow Banking.
Options	A form of derivative contract which gives investors the option of buying or selling a financial instrument/ asset at a specified time and price in the future. The investor pays a premium to obtain the option to do so. Unlike a future, the investor does not have to buy the underlying asset at that time and at that price. But, the seller of the option is obliged to sell the asset on those terms. Can be used for genuine hedging purposes or for speculation.
Payment systems	A payment system is a system which allows transactions and payments to take place. Payment systems include the large infrastructures that allow wages to be paid and also include the ATM network, debit cards, credit cards, e-commerce transactions etc. Clearing and settlement systems allow

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	transactions in bond, equity, and derivatives markets to be cleared and settled – see above.
Pension Funds/ Schemes	A pension fund is a scheme which allows people to accumulate assets for retirement on a tax-advantaged basis. There are various types. Employers (or occupational) pension schemes which are operated by employers for their staff and which the employer contributes to. Usually employers will hire institutional fund managers to actually manage the investments. Personal pensions are designed for individuals to save for retirement and are run by insurance companies. Pension funds as major holders of company shares/ bonds, government bonds, and as private investors are important providers of capital to the real economy.
Primary markets	See Capital Markets, above.
Prime brokerage	Prime brokerage refers to services offered by investment banks to hedge funds to allow them to leverage investments.
Private Equity	Private equity funds raise money from investors to invest in companies. Investors can then exit the investments by selling to another private investor or more commonly floated on the market. Private equity funds will usually finance some of the investment through borrowing.
Retail financial services	Retail financial services relates to financial products and services used by ordinary (or retail consumers).
Secondary markets	See Capital Markets, above.
Securitisation	Securitisation is a method of pooling or packaging types of loans (mortgages, credit card payments, car loans) in a special financial vehicle (called a Special Purpose Vehicle) so they can be sold to investors who looking for an income stream (this comes from the interest payments and principal on the underlying loans). Common types of securitisation include: mortgage backed securities (MBS) where the income stream is backed by mortgage payments and asset backed securities (ABS) where the income stream is backed from other types of loans. In theory, the pooling of these different types of loans should reduce the risk through diversification. However, securitisation has been criticised for becoming too complex which can make it difficult for the end-investor to understand the true risks they are exposed to. It played a critical role in the sub-prime mortgage crisis which triggered the global financial crisis in 2007/08.

Shadow banking/ Other financial intermediaries	This is a general term for financial institutions which act as intermediaries between investors and borrowers but which sit outside the banking system. Examples include money market funds, finance companies, structured finance vehicles, hedge funds, real estate investment trusts and funds, peer-to-peer (P2P) lending.
Sovereign wealth funds	Sovereign wealth funds are state owned investment funds built up for example from oil revenues. These have generally been set up for two reasons either to pre-fund future public services or stabilise current public spending (for example to make up shortfalls if current taxation isn't enough to pay for current public spending needs).
Special Purpose Vehicles (SPVs)	See Securitisation.
Stock exchanges	An exchange where traders and stockbrokers can buy and sell shares, bonds and other securities.
Stockbrokers/ brokers	Stockbrokers are professionals who buy and sell shares, bonds and other securities on behalf of clients.
SWAPS	As the name suggests, a SWAP is a transaction where one financial institution (or company) will swap the cash flows from a particular financial instrument in exchange for another. For example, a company with a fixed rate loan may decide it would benefit from making variable (or floating) rate payments. In effect, the SWAP contract can transform a fixed rate loan into a variable (floating) rate loan. The SWAP is arranged through a SWAP broker or dealer – typically an investment bank. Similarly, currency SWAPS allow two parties to swap principal and interest payments on loans in one currency for another. SWAPS can be used for hedging risk or for speculating.
UCITS funds	UCITS stands for Undertaking in Collective Investment in Transferable Securities. These are collective investment schemes (see above) which, if authorised in one Member State of the European Union, can be sold across the whole EU.
UCIS funds	UCIS funds are unregulated collective investment schemes. These tend to invest in more unusual assets such as film schemes, plantations, and overseas property. These are not regulated by the FCA although can be sold in the UK but only to limited types of investor such as certified high net worth and sophisticated investors.

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<p>Underwriting/underwriters</p>	<p>Underwriting plays a critical role in managing risk in the financial system. Financial institutions (for example, insurers and investment banks) underwrite or guarantee payment in the event of financial loss. In the insurance market, underwriters evaluate the risks involved for an insurer and determine the premiums clients should pay. In the primary capital markets, governments and companies raise money from investors by issuing bonds (governments and companies) or equity (companies). However, there is a risk when issuing bonds and equity that there won't be enough interest from investors which means that there will be a shortfall in the capital raised. The investment bank managing the capital raising will also arrange for a syndicate to help sell the bonds/ equity to investors and underwrite this risk. If some bonds/ equities are left unsold, the syndicate will have to retain ownership themselves.</p>
<p>Unit trusts/ OEICs</p>	<p>Unit trusts are a type of open-ended collective investment fund. Unit trusts are managed by a fund manager who buys shares in companies or bonds on behalf of the fund. The fund is divided up into units which are bought and sold by investors. When new investors come into the fund the manager creates new units. When investors sell, the fund manager cancels units. The price of the units depends on the value of the underlying assets held in the fund. Open Ended Investment Companies (OEICs) are like unit trusts except that these are run as a company not a trust and the fund manager creates and cancels shares rather than units. These are known as 'open-ended' because the number of units/ shares that can be created to meet investor demand isn't limited.</p>
<p>Venture capital providers and managers</p>	<p>Venture capital is a form of private equity investment. Venture capital providers tend to invest at the very early stages of a company's development. They take equity stakes in the company and will aim to produce a return by selling their stake when the company goes through an IPO or is sold to another buyer.</p>
<p>Reinsurance</p>	<p>When insurers insure large risks, they will try to manage their exposure to potential losses by reinsuring these risks with other insurers. This can be done by specialist reinsurers or other insurers.</p>

Wholesale markets	Wholesale markets generally refer to primary and secondary capital markets, financial market infrastructures, corporate and investment banking and to business-to-business financial activities between large actors in the financial system such as investment banks and hedge funds, and dealings with large corporate clients in the real economy.
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